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SUPREME COURT, U.S.

TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1954

No. 114

GENERAL AMERICAN INVESTORS COMPANY, INC.,
PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

PETITION FOR CERTIORARI FILED JUNE 4, 1954
CERTIORARI GRANTED OCTOBER 14, 1954

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United States Court of Appeals

FOR THE SECOND CIRCUIT.

GENERAL AMERICAN INVESTORS COMPANY, INC., Petitioner, *v.* COMMISSIONER OF INTERNAL REVENUE, Respondent.	Docket No. 36220.

Appearances:

For Petitioner:

JOHN F. DOOLING, JR. Esq.
NORRIS DARRELL, Esq.

For Respondent:

ARTHUR L. NIMS, Esq.

Docket Entries.

(T. R. 1)

1951

Aug. 16—Petition received and filed. Taxpayer notified. Fee paid.
" 16—Copy of petition served on General Counsel.
" 16—Request for Circuit hearing in New York filed by taxpayer. 8/27/51 Granted.
" 16—Motion to amend petition, embodying amendment, filed by taxpayer. Copy served.
Sept. 17—Answer filed by General Counsel.
" 19—Copy of answer served on taxpayer, New York.

Docket Entries.

1952

Feb. 13—Hearing set April 28, 1952, New York, New York.
Apr. 28—Hearing had before Judge Black, on merits. Appearance of Robert A. McDowell filed. Stipulation of facts filed. Briefs due July 1, 1952. Replies due July 20. 1952.
May 20—Transcript of hearing 4/28/52 filed.
June 30—Brief filed by taxpayer. Copy served 7/2/52.
July 1—Entry of appearance of Norris Darrell filed.
" 1—Brief filed by General Counsel.
" 21—Reply brief filed by taxpayer. Copy served.
" 21—Reply brief filed by General Counsel.
Dec. 30—Findings of fact and opinion rendered, Black, Judge. Decision will be entered for the respondent. Copy served.
" 31—Decision entered, Eugene Black, Judge, Div. 15.

1953

Mar. 26—Petition for review by U. S. Court of Appeals, Second Circuit, with assignments of error filed by petitioner.
" 26—Proof of service filed.
" 26—Praecipe for and designation of contents of record filed by petitioner.
" 26—Proof of service of designation of contents of record filed.
Apr. 6—Proof of service of petition for review, praecipe for and designation of contents of record filed by taxpayer.

Findings of Fact and Opinion.

(T. R. 19-23).

[Same Caption]

Docket No. 36220 Promulgated December 30, 1952

Respondent determined a deficiency of $57,922.55 for the calendar year 1948. By appropriate assignment of error petitioner contests the entire deficiency and alleges the following error:

> The Commissioner erroneously determined that the petitioner realized taxable income of $157,038.04 by its receipt in 1948 of $170,038.04 (in connection with the receipt of which it was entitled to an allowance of legal expenses of at least $13,000 which it did not deduct on its return) pursuant to Section 30(f) of the Investment Company Act of 1940 and Section 16(b) of the Securities Exchange Act of 1934.

Findings of Fact.

All the facts have been stipulated and are found accordingly.

Petitioner is a corporation organized under the laws of the State of Delaware, with its principal office at 44 Wall Street, New York 5, New York. Petitioner is a registered closed-end investment company as defined in the Investment Company Act of 1940.

A Federal income tax return for the calendar year 1948, prepared on an accrual basis, was filed by petitioner with the collector of internal revenue for the second district of New York.

On or about April 1, 1944, an individual who was one of petitioner's directors, hereinafter referred to as "Director," acquired warrants to purchase shares of the common stock of petitioner at five different prices ranging from $10

to $20 per share, the warrants covering an equal number of shares at each price. On the basis of his average cost of all the warrants then so acquired, the warrants to purchase 12,228 shares of petitioner's common stock which he exercised as stated hereafter had a cost basis to the Director of $4,800.

On or about April 1, 1944, a second individual, hereinafter referred to as "Stockholder" also acquired warrants of the type referred to above. On the basis of his average costs of all the warrants then so acquired, the warrants to purchase 27,027 of the 28,532 shares of petitioner's common stock which he exercised as stated hereafter had a cost basis to the Stockholder of $10,609.22. The Stockholder owned more than 10 per cent of the then outstanding warrants at all times between June 5, 1945 and June 17, 1946.

Between June 5, 1945 and June 17, 1946, the Director, individually and through a partnership of which he was a member, sold on the New York Stock Exchange an aggregate of more than 12,228 shares of petitioner's common stock in blocks of various sizes and for various amounts. Between June 5, 1945 and June 17, 1946, the Stockholder, individually and through a partnership of which he was a member, sold on the New York Stock Exchange 27,027 shares of petitioner's common stock in blocks of various sizes and for various amounts.

On December 4 and 18, 1945, the Director exercised warrants to purchase an aggregate of 12,228 shares of Petitioner's common stock at an average purchase price of $13.75 per share. On December 4 and 18, 1945, the Stockholder exercised warrants to purchase 28,532 shares of petitioner's common stock at an average purchase price of $13.75 per share. Of the proceeds received by the petitioner at the time of the exercise of the warrants by the said persons, $1.00 per share was credited to the petitioner's capital account and the balance thereof was credited to the petitioner's capital surplus account.

Findings of Fact and Opinion.

Pursuant to the provisions of section 30(f) of the Investment Company Act of 1940 and section 16(b) of the Securities Exchange Act of 1934, the above-described persons were required to pay in to the petitioner certain "profits" (as that term is used in the Securities Exchange Act of 1934) which they had realized upon the sale and purchase, or purchase and sale, of petitioner's common stock during the period June 5, 1945 to June 17, 1946, inclusive. The only purchases of petitioner's common stock by the above-described persons during said period were the purchases upon the exercise of the warrants described above. The determination of the "profits" so realized is tabulated as follows:

	Stockholder		Director	
	Shares	Amount	Shares	Amount
a. Proceeds of Sales..	27,027	$511,593.42	12,228	$254,027.33
b. Subscription to Common Stock....	27,027	371,621.25	12,228	168,135.00
c. Cost of Warrants....		10,609.22		4,800.00
d. Calculated "Profit" on sales required to be paid in to petitioner (line a minus the sum of lines b and c).....		$129,362.95		$ 81,092.33

Of the above set forth amount of $81,092.33 required to be paid by the Director, $40,417.24 was paid by him to the petitioner on March 9, 1946, and the remainder thereof, together with the entire amount required to be paid by the Stockholder, was paid to petitioner on January 26, 1948. These amounts received by petitioner were received without litigation and were paid by the said persons upon the advice of their counsel that they were liable to petitioner therefor.

The $40,417.24 received in 1946 from the Director was in that year credited to petitioner's capital surplus account. The amounts received from the said persons in 1948 as

aforesaid were recorded by petitioner in its cash book as "Capital Surplus—add'l amt recd in connection with common stock issued in 1945," and the aggregate amount so received in 1948 was credited to petitioner's capital surplus account. Thereafter, on March 31, 1948 (after receiving a letter-ruling from the Bureau of Internal Revenue dated February 26, 1948, to the general effect that the said amount received in 1948 should be returned as income), petitioner debited its capital surplus account for the said amount and credited a receipts-in-suspense account with an equal amount. At the close of the year 1948, the receipts-in-suspense account was debited with the amount of a reserve for taxes in respect of the amounts received in 1946 and 1948, and with the amount of legal expenses incurred up to December 31, 1948, in respect of the amounts recovered in that year, and the balance of $92,038.04 in said receipts-in-suspense account was simultaneously transferred to capital surplus.

Petitioner expended the sum of $13,000 as legal fees in connection with the recovery of the amounts due from the Director and the Stockholder, which fees respondent allowed as a credit against the gross amount received.

From the foregoing facts we find the following ultimate facts: The amounts which were paid to the petitioner by the Director and by the Stockholder under compulsion of section 16(b) of the Securities Exchange Act of 1934 and section 30(f) of the Investment Company Act of 1940 constituted gross income to the petitioner for the year 1948.

OPINION.

BLACK, *Judge:* The applicable statutes in this proceeding are section 22(a) of the Internal Revenue Code, section 30(f) of the Investment Company Act of 1940, 54 Stat. 837, 15 U. S. C. section 80a-29(f) and section 16(b) of the Securities Exchange Act of 1934, 48 Stat. 896, 15 U. S. C. section 78p(b). Section 22(a) of the Code is so familiar that it is unnecessary to incorporate it herein. The other

two applicable statutory provisions are printed in the margin.[1]

The only question presented is whether amounts which were paid to the petitioner in 1948 by certain persons under

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[1] Section 30(f) of the Investment Company Act of 1940, 54 Stat. 837, 15 U. S. C. section 80a-29(f):

> (f) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of outstanding securities (other than short-term paper) of which a registered closed-end company is the issuer or who is an officer, director, member of an advisory board, investment adviser, or affiliated person of an investment adviser of such a company shall in respect of his transactions in any securities of such company (other than short-term paper) be subject to the same duties and liabilities as those imposed by section 16 of the Securities Exchange Act of 1934 upon certain beneficial owners, directors, and officers in respect of their transactions in certain equity securities.

Section 16(b) of the Securities Exchange Act of 1934, 48 Stat. 896, 15 U. S. C. section 78p(b):

> (b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

compulsion of section 16(b) of the Securities Exchange Act of 1934 and section 30(f) of the Investment Company Act of 1940, both printed in the margin, constitute income to the petitioner. The statutes in question were designed to curb the abuses of short-term speculations in securities based on inside information or power to manipulate corporate policy. See Sen. Rep. No. 792 at pp. 7-9, 73d Cong., 2d Sess. (1934). *William F. Davis, Jr.*, 17 T. C. 549. Section 16(b), *supra*, provides that any profits realized by corporate insiders from "any purchase and sale, or any sale and purchase, of any equity security • • • [of their own corporation] within any period of less than six months, • • • shall inure to and be recoverable by" the corporation.

The instant case presents the same issue as was involved in *Park & Tilford Distillers Corp.* v. *United States*, (Ct. Cl.) ..... F. Supp. ....., decided November 4, 1952. The Court of Claims held that the "insider profits" were taxable income to the recipient corporation under the broad provisions of section 22(a), I. R. C., as "gains or profits and income derived from any source whatever." The fact that the income represented nondeductible penalty payments to the payors was not deemed to militate against their taxability.

Petitioner in its brief argues that:

> "• • • the relevant fact is that a section 16(b) recovery does not compensate the issuer for any impairment of capital or loss of profits; it does not result from any activity on the part of the issuer, but if not received by it as part of the subscription price for its stock, is a pure windfall, gratuitously received."

Petitioner argues further in its brief, as follows:

> "• • • In the present instance, however, as the respondent concedes, the Section 16(b) recovery was not a restitution to make the issuer whole for a loss of corporate profits, or even of corporate capital; it

was a pure windfall, measured by an objective measure of proof having no relationship to the actual profit of the fiduciary or to any loss by the corporation. It did not result from any action on the part of the corporation nor was it derived from corporate capital or the labor of corporate employees. If it were true that a Section 16(b) recovery amounts in effect to a payment 'into the corporate treasury of profits which may • • • have been realized at the expense of the outside stockholders,' it would nevertheless be a windfall or gratuitous contribution from the standpoint of the corporation."

It seems to us that the Court of Claims in the *Park & Tilford* case, *supra,* took into consideration much the same arguments as petitioner here uses and rejected them and held against the taxpayer there involved. We agree with the conclusion reached by the Court of Claims that the payments thus received were taxable income and decide the issue here involved against petitioner. The Court of Claims discussed the issue involved in a comprehensive manner and we feel it unnecessary to here repeat at any great length what the court there said.

We think it is appropriate, however, that we should say that our decisions in *Edward H. Clark,* 40 B. T. A. 333 and *Highland Farms Corporation,* 42 B. T. A. 1314 to which the Court of Claims referred in the concluding paragraph of its opinion are clearly distinguishable on their facts from the instant case. The *Clark* case was a case where in the taxable year the petitioner received a sum of money from his tax counsel as recompense for an error made by the latter in preparing and filing petitioner's 1932 return, the error having caused petitioner to pay more tax than he would have owed had the correct method been employed. Under such circumstances, we held that the compensatory payment was not includible in the taxpayer's gross income. In the *Highland Farm Corporation* case we held that dam-

ages against a bank mortgage awarded to a corporation for injuries resulting from a course of conduct pursued by the bank's president against the corporation was a restoration of lost capital and not taxable income. We also held in that case that punitive damages recovered by the taxpayer were not taxable income to it. We do not think that either of these cases are in conflict with our decision here.

Petitioner urges in its brief that our recent decision in *Glenshaw Glass Co.*, 18 T. C. ....., promulgated August 13, 1952, is apposite here. In that case we said:

> "The first issue is whether the sums received in settlement of the punitive damages claims constitute taxable income. It has long been established that punitive damages do not meet the test of taxable income set forth in *Eisner* v. *Macomber*, 252 U. S. 189, 193, as '"• • • the gain derived from capital, from labor, or from both combined", provided it be understood to include profit gained through a sale or conversion of capital assets • • •.' *Central R. Co.* v. *Commissioner*, 79 F. 2d 697; *Highland Farms Corporation*, 42 B. T. A. 1314. This basic definition has been recently cited with complete approval in *Commissioner* v. *Culbertson*, 337 U. S. 733, 740, and has been adhered to by the respondent in his Regulations 111, section 29.22(a)-1. Therefore, on the authority of those cases, we follow this rule of long standing that has never been questioned in any court and hold that the sums received in settlement of the punitive damages claims do not constitute taxable income."

The $170,038.04 here involved was not received by petitioner in payment of punitive damages. We do not think *Glenshaw Glass Co., supra,* which dealt with punitive damages paid to the taxpayer corporation is controlling here.

Petitioner here raises two alternative arguments that were not discussed in the *Park & Tilford* case, *supra.* Peti-

tioner characterizes the amounts in question as a capital contribution, citing *Edwards* v. *Cuba R. R. Co.*, 268 U. S. 628 and *Brown Shoe Co.* v. *Commissioner*, 339 U. S. 583. However, since the corporation had unrestricted discretion to use the funds for any purpose whatsoever, *Texas & Pacific Railway Co.* v. *United States*, 286 U. S. 285, and received a windfall benefit by operation of a Federal statute, there is no capital contribution.

Petitioner also contends that the amounts paid in constituted additional payments on the original issuance price of the stock, citing no authority. We do not think that the facts which have been stipulated sustain petitioner in that contention.

It seems to us under the facts which have been stipulated, we must hold that the amounts here involved were not payments of part of the purchase price of petitioner's stock acquired by its Director and its Stockholder and cannot be so treated. We hold, therefore, that the sums in question are income to petitioner under section 22(a), I. R. C.

Reviewed by the Court.

Decision will be entered for the respondent.

TIETJENS, *J.*, concurs in the result.

ARUNDELL, *J.*, dissents.

MURDOCK, *J.*, concurring: Section 16(b) of the Securities Exchange Act of 1934 provided that "any profit realized" under circumstances like those here present "shall inure to and be recoverable by the issuer," that is, the corporation. Thus the profits here in question were income of the petitioner within the words and intention of section 22(a) since they were "profits" either from "sales or deal-

ings in property • • • growing out of the ownership of • • • or interest in such property" or "from any source whatsoever."

VAN FOSSAN and TURNER, *JJ.*, agree with this concurring opinion.

Decision.

(T. R. 30)

[SAME CAPTION]

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion promulgated December 30, 1952, it is

ORDERED AND DECIDED: that for the calendar year 1948 there is a deficiency in income tax in the amount of $57,922.55.

Entered Dec 31 1952

Enter:

EUGENE BLACK,
Judge.

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 29—October Term, 1953.

(Argued February 9, 1954 Decided March 9, 1954.)

Docket No. 22718

GENERAL AMERICAN INVESTORS COMPANY, INC.,
Petitioner,

— v. —

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Before:

CHASE, *Chief Judge,*

A. N. HAND and MEDINA, *Circuit Judges.*

On petition for review from a decision of the Tax Court of the United States, reported in 19 T. C. 531. AFFIRMED.

NORRIS DARRELL, JOHN F. DOOLING, JR. and ROBERT A. MCDOWELL, *Attorneys for Petitioner,* Sullivan & Cromwell, of Counsel.

H. BRIAN HOLLAND, Assistant Attorney General, Ellis N. Slack and Morton K. Rothschild, Special Assistants to the Attorney General, *for Respondent.*

EDINA, *Circuit Judge:*

The appeal in this case involves a deficiency in income ax for the calendar year 1948 in the amount of $57,922.55. n compliance with Section 30(f) of the Investment Com- any Act of 1940 and Section 16(b) of the Securities Ex- hange Act of 1934, a director, and a stockholder owning ore than 10% of the outstanding warrants for the pur- hase of petitioner's stock, who had realized profits in the espective sums of $81,092.33 and $129,362.95, paid these ums into the treasury of petitioner, as they were so-called short-swing profits" realized by an "insider" within the eaning of said Section 16(b), as construed and applied in *molowe* v. *Delendo Corp.*, 136 F. 2d 231 (2nd Cir., 1943). ertiorari denied, 320 U.S. 751.

Under similar circumstances moneys thus received by a orporation were held by the Court of Claims to be "gains r profits and income derived from any source whatever," ithin the meaning of Section 22(a) of the Internal Reve- ue Code. *Park & Tilford Distillers Corp.* v. *United States,* 07 F. Supp. 941, certiorari denied, 345 U. S. 917.

Petitioner relies principally upon the following definition f income contained in the opinion of the Supreme Court n the stock dividend case of *Eisner* v. *Macomber,* 252 U. S. 89, 207 (1920):

> " 'Income may be defined as the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets. * * * "

If this definition is to be regarded as all inclusive, and o be applied literally, it does not reach the payments to etitioner with which we are now concerned. And the range f discussion in the briefs and oral arguments before us has overed many situations said to be analogous, including tort

recoveries of punitive or exemplary damages in defamation cases, two-thirds of the triple damage awards in private antitrust suits, so-called "penalties" imposed upon faithless fiduciaries and others.[1]

Is there some common principle or touchstone by the application of which one may infallibly determine what is and what is not in a given case "gains or profits and income derived from any source whatever"? We think not. The old definition of *Eisner* v. *Macomber* was perhaps contrived in the hope that a final and definitive solution had been found. But by reason of the very nature of the subject matter this was not to be. The decision in *Eisner* v. *Macomber* still stands, but the definition has met the common fate of generalities, and it has long since given way to an empirical case by case approach, which has the virtue of elasticity and makes possible a more sensible solution of new problems as they arise.[2]

Policy considerations may in the end play a decisive or persuasive role in the punitive damage, antitrust and faithless fiduciary cases. For, despite the fact that the moneys received in those instances are at the free disposal of those to whom they are paid, and the rationale of such tribunals as have held them not to be "income" is based principally upon the *Eisner v. Macomber* definition, it may be thought by some that the public interest will be better served if such

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[1] See *Highland Farms Corp.*, 42 B. T. A. 1314 (1940); *Glenshaw Glass Co.*, 18 T. C. 860 (1952); *William Goldman Theatres, Inc.*, 19 T. C. No. 79 (1953); and *Central R. Co. of New Jersey* v. *Commissioner*, 79 F. 2d 697 (3rd Cir., 1935), where property in possession of a trustee *ex maleficio* was turned over to a corporation and held not to constitute "income," as "It was a penalty imposed by law on a faithless fiduciary, a gain granted gratuitously because of the necessity of keeping persons in positions of trust beyond the temptation of double dealing."

[2] Cf. Surrey & Warren, "A. L. I. Income Tax Project," 66 Harvard Law Rev. 761, 771 (1953). See also, *Rutkin* v. *United States*, 343 U. S. 130, rehearing denied 343 U. S. 952 (1952).

receipts are held not to be subject to the income tax. It is on some such basis that a taxpayer, who included "short-swing" profits in his gross income, has been denied deductions for payments of these same profits over to the corporations of which he was a director, officer or stockholder, as required by Section 16(b) of the Securities Exchange Act of 1934.[3] However imponderable or remote or difficult of ascertainment such policy questions may be we express no opinion thereon. Perhaps they have no relevance to the problem, and the Court of Claims was right when it expressed the view that *Central R. Co. of New Jersey* v. *Commissioner* and *Highland Farms Corp.* (see footnote 1, *supra*) were wrongly decided. *Park & Tilford Distillers Corp.* v. *United States, supra,* at p. 945. In any event, no considerations of policy would seem to affect this case one way or the other, since the beneficent purpose of Section 16(b) will be served equally well whether or not these payments are held to be "income" to petitioner.

It is at least clear that the answer is not to be found in mere terminology. Thus it will not help to characterize these payments as a "windfall" to the corporation or as in the nature of a "penalty" imposed upon the director and the stockholder.

In *United States* v. *Kirby Lumber Co.*, 284 U. S. 1 (1931), a corporation retired some of its own bonds after purchasing them at a price less than the face value, which it had received for them when issued, and it was held that the excess of the issuing price over the purchase price constituted "gains or profits and income from any source whatever," despite the fact that the *Eisner* v. *Macomber* definition could hardly be said to cover the case. Justice Holmes, writing for a unanimous court in that case, over ten years after *Eisner* v. *Macomber,* used these words (p. 3):

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[3] William F. Davis, Jr., 17 T. C. 549 (1951).

> "We see nothing to be gained by the discussion of judicial definitions. The defendant in error has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here."

So now, if we consider the words "gains or profits and income from any source," "in their plain popular meaning," as we think they should be, how can there be any doubt that these Section 16(b) payments are "income"?

Petitioner had unrestricted discretion to use the funds for any purpose whatsoever; they were in no sense donations or contributions to capital, or payments by way of restoration of lost capital, or compensation for any loss suffered by petitioner. Doubtless the subject in general is technical and often recourse is properly had to complicated and abstruse accounting practices; but here the issue is simplicity itself. Accordingly, we hold the sums thus received to be "income" to petitioner within the meaning of Section 22(a).

Perhaps reluctant to take a position seemingly inconsistent with prior decisions of the Tax Court, which relied heavily upon the *Eisner* v. *Macomber* definition and upon *Central R. Co. of New Jersey* v. *Commissioner*, 79 F. 2d 697 (3rd Cir., 1935), *supra*, the concurring judges below took the view that these payments were "profits," because Section 16(b) provided that "any profit realized" under the circumstances here present "shall enure to and be recoverable by the issuer." But this reasoning will not bear analysis. These payments were not "profits" to petitioner, although they represented "profits" realized by the director and the stockholder.

Petitioner's further contention that these payments were "part of the subscription price received upon issue of the stock in question" flies in the face of the realities of the

stock purchase transactions, which were complete when the stock was purchased through the exercise of the warrants. No bookkeeping entries made after the receipt by petitioner of these Section 16(b) payments could alter these basic facts. It is immaterial that the stock was not purchased on the open market.

Affirmed.

UNITED STATES COURT OF APPEALS, SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court house in the City of New York, on the 9th day of March one thousand nine hundred and fifty-four.

Present: Hon. Harrie B. Chase, Chief Judge; Hon. Augustus N. Hand, Hon. Harold R. Medina, Circuit Judges.

GENERAL AMERICAN INVESTORS CO., INC., Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Appeal from The Tax Court of the United States

This cause came on to be heard on the transcript of record from The Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

It is further ordered that a Mandate issue to the said The Tax Court of the United States in accordance with this decree.

(S.) A. Daniel Fusaro, Clerk.

[Endorsed:] United States Court of Appeals, Second Circuit. General American Investors Co., v. Commissioner of Internal Revenue. (29). Judgment. United States Court of Appeals, Second Circuit. Filed Mar. 9, 1954. A. Daniel Musaro, Clerk.

Clerk's printing.

Clerk's Certificate to foregoing transcript omitted in printing.

[fol. 23] THE TAX COURT OF THE UNITED STATES

Docket No. 36220

GENERAL AMERICAN INVESTORS COMPANY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

STIPULATION OF FACTS

It is hereby stipulated and agreed by and between the parties hereto, by their respective counsel, that the following facts shall be taken as true for the purposes of this proceeding, without prejudice to the right of either party to introduce other and further evidence not inconsistent with the facts herein stipulated to be true, and subject to the right of either party to object to the relevancy or materiality of any of the stipulated facts.

1. Petitioner is a corporation organized under the laws of the State of Delaware, with its principal office at 44 Wall Street, New York 5, N. Y. Petitioner is a registered closed-end investment company as defined in the Investment Company Act of 1940.

2. A Federal income tax return for the calendar year 1948, prepared on an accrual basis, was filed by petitioner with the Collector of Internal Revenue for the Second District of New York.

[fol. 24] 3. On or about April 1, 1944, an individual who was one of petitioner's directors, hereinafter referred to as "Director," acquired warrants to purchase shares of the common stock of petitioner at five different prices ranging from $10 to $20 per share, the warrants covering an equal number of shares at each price. On the basis of his average cost of all the warrants then so acquired, the warrants to purchase 12,228 shares of petitioner's common stock which he exercised as stated below had a cost basis to the Director of $4,800.

4. On or about April 1, 1944, a second individual, hereinafter referred to as "Stockholder," also acquired warrants of the type referred to in Paragraph 3. On the basis of his average costs of all the warrants then so acquired, the

warrants to purchase 27,027 of the 28,532 shares of petitioner's common stock which he exercised as stated below had a cost basis to the Stockholder of $10,609.22. The Stockholder owned more than 10 per cent of the then outstanding warrants at all times between June 5, 1945 and June 17, 1946.

5. Between June 5, 1945, and June 17, 1946, the Director, individually, and through a partnership of which he was a member, sold on the New York Stock Exchange an aggregate of more than 12,228 shares of petitioner's common stock in blocks of various sizes and for various amounts.

Between June 5, 1945, and June 17, 1946, the Stockholder, individually and through a partnership of which he was [fol. 25] a member, sold on the New York Stock Exchange 27,027 shares of petitioner's common stock in blocks of various sizes and for various amounts.

6. On December 4 and 18, 1945 the Director exercised warrants to purchase an aggregate of 12,228 shares of petitioner's common stock at an average purchase price of $13.75 per share.

On December 4 and 18, 1945 the Stockholder exercised warrants to purchase 28,532 shares of petitioner's common stock at an average purchase price of $13.75 per share.

7. Of the proceeds received by the petitioner at the time of the exercise of the warrants by the said persons, $1 per share was credited to the petitioner's capital account and the balance thereof was credited to the petitioner's capital surplus account.

8. Pursuant to the provisions of Section 30(f) of the Investment Company Act of 1940, 54 Stat. 836, (1940), 15 U.S.C. Section 80(a)-29, and Section 16(b) of the Securities Exchange Act of 1934, 48 Stat. 896 (1934), 15 U.S.C. Section 78(p), the above-described persons were required to pay in to the petitioner certain "profits" (as that term is used in the Securities Exchange Act of 1934) which they had realized upon the sale and purchase, or purchase and sale, of petitioner's common stock during the period June 5, 1945, to June 17, 1946, inclusive. The only purchases of petitioner's common stock by the above-described persons during said period were the purchases upon the exercise of the warrants described in paragraph 6 above.

[fol. 26] The determination of the "profits" so realized is tabulated as follows:

	Stockholder		Director	
	Shares	Amount	Shares	Amount
a. Proceeds of Sales	27,027	$511,593.42	12,228	$254,027.33
b. Subscription to Common Stock	27,027	371,621.25	12,228	168,135.00
c. Cost of Warrants	.....	10,609.22	.....	4,800.00
d. Calculated "Profit" on sales required to be paid in to petitioner (line a minus the sum of lines b and c)	.....	$129,362.95	.....	$ 81,092.33

Of the above set forth amount of $81,092.33 required to be paid by the Director, $40,417.24 was paid by him to the petitioner on March 9, 1946, and the remainder thereof, together with the entire amount required to be paid by the Stockholder, was paid to petitioner on January 26, 1948.

9. The said amounts received by petitioner as aforesaid were received without litigation and were paid by the said persons upon the advice of their counsel that they were liable to petitioner therefor.

10. The $40,417.24 received in 1946 from the Director was in that year credited to petitioner's capital surplus account. The amounts received from the said persons in 1948 as aforesaid were recorded by petitioner in its cash book as "Capital Surplus—add'l amt recd in connection with common stock issued in 1945," and the aggregate [fol. 27] amount so received in 1948 was credited to petitioner's capital surplus account. Thereafter, on March 31, 1948 (after receiving a letter-ruling from the Bureau of Internal Revenue dated February 26, 1948, to the general effect that the said amount received in 1948 should be returned as income), petitioner debited its capital surplus account for the said amount and credited a Receipts-in-Suspense Account with an equal amount. At the close of the year 1948 the Receipts-in-Suspense Account was debited with the amount of a reserve for taxes in respect of the amounts received in 1946 and 1948, and with the amount of legal expenses incurred up to December 31, 1948, in respect of the amounts recovered in that year, and the

balance of $92,038.04 in said Receipts-in-Suspense Account was simultaneously transferred to capital surplus.

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[fol. 28] SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1954

No. 114

GENERAL AMERICAN INVESTORS COMPANY, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ORDER ALLOWING CERTIORARI—Filed October 14, 1954

The petition herein for a writ of certiorari to the United States Court of Appeals for the Second Circuit is granted, and the case is transferred to the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

COPY
SUPREME COURT, U.S.

No. [redacted] 114

Office - Supreme Court, U. S.
FILED
JUN 4 1954
HAROLD B. WILLEY, Clerk

IN THE

Supreme Court of the United States

OCTOBER TERM, 1954

GENERAL AMERICAN INVESTORS COMPANY, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1954

No.

GENERAL AMERICAN INVESTORS COMPANY, INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in the above entitled case on March 9, 1954.

Opinions Below

The opinion of the Tax Court (R. 3) is reported at 19 T. C. 581. The opinion of the Court of Appeals is reported at 211 F. 2d 522.

Jurisdiction

The judgment of the Court of Appeals was entered on March 9, 1954. The jurisdiction of this Court is invoked under 28 U. S. C. § 1254 (1) and Section 1141 (a) of the Internal Revenue Code.

Question Presented

The sole question presented is whether $170,038.04 received by the petitioner in 1948 from a director and a stockholder in satisfaction of "insider" liabilities for "short-swing profits", imposed by Section 30(f) of the Investment Company Act of 1940 and Section 16(b) of the Securities Exchange Act of 1934, was includible in petitioner's "gross income".

Statutes and Regulations Involved

Section 22(a) of the Internal Revenue Code:

> "(a) GENERAL DEFINITION.—'Gross income' includes gains, profits, and income derived, from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever . . ."

U. S. Treas. Reg. 111, Sec. 29.22(a)-1:

> "*What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22(b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include

profit gained through sale or conversion of capital assets. Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens and foreign corporations by sections 211 to 237 inclusive, and, in certain cases, by section 251, for citizens and domestic corporations deriving income from sources within possessions of the United States. Income may be in the form of cash or property."

Section 30(f) of the Investment Company Act of 1940, 15 U. S. C. § 80a-29(f):

"(f) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of outstanding securities (other than short-term paper) of which a registered closed-end company is the issuer or who is an officer, director, member of an advisory board, investment adviser, or affiliated person of an investment adviser of such a company shall in respect of his transactions in any securities of such company (other than short-term paper) be subject to the same duties and liabilities as those imposed by section 16 of the Securities Exchange Act of 1934 upon certain beneficial owners, directors, and officers in respect of their transactions in certain equity securities."

Section 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78p(b):

"(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in

entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

Statement

The pertinent facts, as they were found by the Tax Court (R. 3-6), are as follows:

Petitioner, a Delaware corporation with its principal office in New York City, is a registered closed-end investment company as defined in the Investment Company Act of 1940. Petitioner filed a Federal income tax return for 1948, prepared on an accrual basis, with the Collector of Internal Revenue for the Second District of New York.

On or about April 1, 1944, one of the petitioner's directors acquired warrants to purchase shares of petitioner's common stock. On or about the same date, a stockholder of petitioner, who at all times between June 5, 1945 and June 17, 1946 owned more than 10% of the then outstanding warrants, also acquired warrants to purchase shares of petitioner's common stock.

Between June 5, 1945 and June 17, 1946, the director, individually and through a partnership of which he was a

member, and the stockholder, individually and through a partnership of which he was a member, sold on the New York Stock Exchange certain shares of petitioner's common stock.

On December 4 and 18, 1945, the director and the stockholder exercised certain of their warrants and purchased shares of petitioner's common stock. These purchases upon the exercise of warrants were the only purchases of common stock of petitioner by the director and the stockholder from June 5, 1945 to June 17, 1946.

Pursuant to Section 30(f) of the Investment Company Act of 1940 and Section 16(b) of the Securities Exchange Act of 1934, the director and the stockholder were required to pay to petitioner certain "profits", as that term is used in the Securities Exchange Act of 1934, realized upon the sales and purchases, or purchases and sales, of shares of petitioner's common stock between June 5, 1945 and June 7, 1946, inclusive. The "profits" were paid by the director and the stockholder to petitioner upon the advice of counsel and without litigation. The "profits" were computed by subtracting from the highest amounts realized by the director and the stockholder on their sales of the stock the average amounts the director and the stockholder had paid to petitioner on the exercise of the warrants plus the average cost of the warrants themselves.

The "profit" required to be paid petitioner by the stockholder as a result of such transactions was computed to be $129,362.95, and the "profit" required to be paid petitioner by the director as a result of such transactions was computed to be $81,092.33. The director paid petitioner $40,417.24 on March 9, 1946, and he paid his remaining $40,675.09 and the stockholder paid his entire $129,362.95, which together total $170,038.04, to petitioner in 1948.

The Tax Court held, with one judge dissenting, that the $170,038.04 received by petitioner in 1948 from the director

and the stockholder was gross income to petitioner, against which petitioner was entitled to deduct an expense of $13,000 incurred as legal fees in recovering that amount.

The decision of the Tax Court was affirmed by the Court of Appeals for the Second Circuit.

Reasons for Granting the Writ and Argument

I

The decision below is in conflict with the recent decision of the Court of Appeals for the Third Circuit in *Commissioner* v. *Glenshaw Glass Co.* (April 9, 1954).*

It is respectfully submitted that the decision below is basically in conflict with the above mentioned decision in *Glenshaw Glass Co.* To be sure, both Courts indicated that the cases might be distinguishable. But each Court attempted to distinguish or indicated the possibility of distinguishing the case in the other Court on grounds which the other Court either expressly rejected or failed to recognize. A third Court, the Court of Claims in *Park & Tilford Distillers Corp.* v. *United States*, 107 F. Supp. 941 (1952), cert. denied 345 U. S. 917 (1953), treated the two situations as indistinguishable.

The decisions are in fact so closely related that their coexistence, without reversal of one or the other, or without an authoritative explanation of the reasons for differing results, can only lead to confusion and invite future controversy.

A. *The decision below.* The Court below was confronted with these facts: Petitioner received sums of money from a director and a 10% stockholder, acting under compulsion of Section 16(b) of the Securities Exchange Act of 1934 as made applicable by Section 30(f) of the Investment Company Act of 1950. It did not obtain these

* The opinion in *Commissioner* v. *Glenshaw Glass Co.* has not yet been reported in the Federal Reporter System. It is reported at 5 CCH Fed. Tax Rep. ¶ 9328 (1954) and is printed as an appendix to this petition.

receipts in pursuit of any gain. It did not expect them. It had no control over the circumstances which led to the receipts. It gave nothing whatsoever in return. No effort or activity on its part generated the receipts. It was in legal effect forced to accept the payments irrespective of its own wishes. The receipts had no relation to petitioner's property or its business activity or to any act or promise or undertaking or forbearance on its part. The receipts were not in substitution for or in replacement of any lost corporate profits. There was no periodicity about them.

Petitioner received the money because Congress, interested as a matter of public policy in deterring possible injury to stockholders through misuse by insiders of inside information, decided to penalize the insider who purchases and sells securities of his corporation within six months by depriving him of any "profit" he might realize therefrom, wholly without reference to whether any inside information was used and even without reference to whether the so-called "profit" is really attributable, in a case such as this, to appreciation in value of stock purchase warrants held for a period considerably longer than six months. Congress could have required the so-called "profit" to be forfeited to the Federal Government or it could have required the forfeited amounts to be distributed among the stockholders for whose protection the provision was enacted. It chose, however, the more convenient course of requiring the forfeited amounts to be paid to the corporation, thus indirectly benefiting all stockholders, and gave the stockholders a right to enforce collection if the corporation failed to do so. In a real sense and in economic effect, from the standpoint of the corporate recipient they resemble legally enforced capital contributions for the benefit of the stockholders. From the standpoint of the insider, the amounts in question were penalties (*Smolowe* v. *Delendo Corp.*, 136 F. 2d 231 (2d Cir. 1943), cert. denied 320 U. S. 751 (1943)), which the insider could not deduct from gross income for

Federal income tax purposes. *William F. Davis, Jr.*, 17 T. C. 549 (1951). In any event, the circumstances giving rise to the obligation to pay and receive were entirely beyond petitioner's control, were not compensation for any injury inflicted on it and had nothing whatsoever to do with its property or its labor or any action or inaction of any kind on its part.

The Court below, affirming the Tax Court, held that the sums received by petitioner constituted income within the meaning of Section 22(a) of the Internal Revenue Code. The Court's reasoning was in substance that there is no common principle or touchstone by the application of which one may infallibly determine what is and what is not income in a given case; that an empirical case-by-case approach must be adopted; that no considerations of policy affect the case one way or the other since the purpose of Section 16(b) will be served equally well whether or no the payments are held to be income to the recipient corporation; that, taking the statutory words "gains or profits and income from any source" in their plain, popular meaning, the Section 16(b) payments constituted income—the petitioner having unrestricted discretion to use the funds for any purpose whatsoever and they being in no sense donations or contributions to capital, payments by way of restoration of lost capital or compensation for any loss suffered by petitioner.

With regard to the cases holding punitive and treble damage recoveries not income, the Court said policy considerations may in the end there play a decisive or persuasive role; but the Court refused to express any opinion thereon, pointing out that such policy considerations may perhaps have no relevance and the Court of Claims may be right in the *Park & Tilford Distillers Corp.* case in saying those cases were wrongly decided.

B. *The decision in Commissioner v. Glenshaw Glass Co.* Here the Court was confronted with these facts:

espondent Glenshaw Glass Co. received money in settle-ent of a suit in which it claimed punitive damages ased upon a competitor's fraudulent suits disastrously ffecting its business, as well as treble damages under Sec-on 4 of the Clayton Act. Respondent William Goldman heatres, Inc. received money in satisfaction of a judgment r treble damages awarded to it pursuant to Section 4 the Clayton Act.

The Court of Appeals for the Third Circuit, affirming ecisions in the Tax Court, held that the punitive and eble damages received over and above actual damages ere not taxable income under Section 22(a) of the In-rnal Revenue Code. In so holding, the Court rejected e government's argument that all money or property oming into a person's hands is taxable as income unless ecifically exempted by statute, saying it had found no se in which the Court did not look to source as at least loring or bearing upon the incidence of taxation. Pay-g considerable allegiance to this Court's definition of in-me in *Eisner* v. *Macomber*, 252 U. S. 189 (1920), and to e requirement that "income" be interpreted as used in mmon speech, the Court said that the payments to the tax-yers in the cases before it could not fairly be regarded products of capital or labor and that in the Court's view e ordinary man regards income as something which mes to him from what he has done, not from something hich is done to him, and would not regard punitive dam-ges, a mere windfall, as income. Recognizing that the sition of the government would bring symmetry into this pect of the law, the Court concluded that if such a result to be achieved it would be effected by this Court.

C. *Similarity in principle between this case and Glen-aw Glass Co.* Petitioner submits there is no logical dis-nction between the treatment of a Section 16(b) recovery nd a punitive or treble damage recovery. The activities ving rise to recovery under Section 16(b) are no less

contrary to public policy than the activities giving rise to the recovery in a punitive or treble damage case.

Though the Court in the *Glenshaw Glass Co.* case said punitive damages seem to be *sui generis,* the Court's reasons for holding them not to be taxable income are strikingly applicable to a Section 16(b) payment also. The Court made the following points in favor of nontaxability of punitive damages.

"By definition they are not compensatory." It can equally be said that a Section 16(b) payment is not compensatory.

"They certainly possess no periodicity." This is true also of a Section 16(b) payment.

"They are not derived from capital, from labor or from both combined and assuredly they are not profit gained through the sale or conversion of capital assets." This too is equally true of a Section 16(b) payment.

Punitive damages "smack of donations made to the individual by the State, by operation of law. A person does a prohibited act to another injuring him. The injured individual is subsequently enriched by a gift taken from the pocket of the injuring party by virtue of law. There is no *quid pro quo.* An analogy seems to us to lie in those cases where contributions are made by the sovereign in the general public interest to an individual. . . . The taxpayers have recovered because the sovereign has seen fit to punish gross behavior for the good of the public. There are naked exactions by the sovereign which go to the injured corporations rather than to the fisc. There is vague likeness to a fine exacted by the sovereign but which goes to the taxpayer." This again is strikingly applicable to a Section 16(b) payment, except of course that the recipient may not have been injured. But the payments in both cases are dictated by the sovereign and are above and beyond any injury.

D. *Invalidity of attempted distinction based on statutory language.* The Court in the *Glenshaw Glass Co.* case presumably recognized the foregoing similarities for it distinguished the Section 16(b) cases on the ground that the making of a profit by the insider is the mainspring of Section 16(b) and that under the operation of the statute, which requires profit to be passed on to the corporation, all the stockholders receive via the corporate entity the profit made by the prohibited transaction. The Court placed particular emphasis upon the concurring opinion in the Tax Court in the present case (R. 11-12) which reasoned in effect that a Section 16(b) payment is income to the corporate recipient since Section 16(b) provides that any "profit realized" by the insider "shall inure to" the issuer. No other reason was given in the *Glenshaw Glass Co.* case for saying that the Section 16(b) cases are distinguishable. Yet the Court below in the present case expressly held that such reasoning will not bear analysis.

In this, the Court below was clearly correct. If a Section 16(b) payment is income to the recipient corporation as a "profit realized" by the insider that "inures to" the corporation, the nature of the income in the hands of the corporation should be the same as in the hands of the offending insider who realized it. If it was a long-term capital gain to him, it should be the same to the corporation.

But this approach encounters difficulties when it is considered that the amount of "profit realized" by the insider for the purpose of Section 16(b) has no necessary relation to the amount of profit realized by the insider for income tax purposes. The former is arrived at by calculating the maximum profit that could have been realized without regard to the profit or loss on the particular stock sold and is not limited to the profit, if any, actually realized as determined under the income tax law. The amount of a Section 16(b) payment is measured under the statute by the excess of the highest sales prices of shares sold during a six

months' period over the lowest purchase prices of shares purchased during such period, without regard to the identity of the shares or certificates purchased or sold. See *Smolowe* v. *Delendo Corp., supra.* In other words, it is a theoretically computed figure having no relation to any actual taxable gain or loss of the insider. The insider may have suffered a capital loss for tax purposes and by virtue of the same sale have a profit payable to the corporation under Section 16(b). It therefore seems wholly fallacious, in determining the status to the recipient of a Section 16(b) payment, to be influenced by the fact that a so-called "profit realized" by the insider is referred to and is made to "inure to and be recoverable by the issuer".

Section 16(b) in referring to "any profit realized" speaks of profit realized by the insider; it is the insider's profit which the statute says "shall inure to and be recoverable by" the issuer. Simply because an item represents profit to one person, it does not follow that it also represents a profit to another to whom the law requires the first person to pay it over. The provision that the insider's profit shall inure to the corporation is simply a device to insure that he shall not benefit from it. While profits technically received by one person may be imputed to another in appropriate circumstances under the doctrine of such cases as *Lucas* v. *Earl*, 281 U. S. 111 (1930), *Helvering* v. *Clifford*, 309 U. S. 331 (1940), and *Helvering* v. *Horst*, 311 U. S. 112 (1940), the profit in such cases is not taxed to both parties but is taxable only to the person to whom the income is imputed because that person is deemed to have earned it or to be the owner of the property producing it. This doctrine has no possible application here. Respondent insists that the insider is taxable on any gain realized in connection with his security transactions, even though the transactions gave rise to liability under Section 16(b). *I. T. 4069*, 1952-1 C. B. 28. Yet, the insider cannot deduct the Section 16(b) payment for income tax purposes since it is a penalty. *William F. Davis, supra.* It is funda-

mentally inconsistent to tax the so-called "profit" to the insider and at the same to tax it to the petitioner because the statute says it shall "inure" to petitioner.

II

The decision below is in conflict with this Court's conception of the characteristic and distinguishing attributes of income for Federal income tax purposes, as expressed more than thirty-three years ago in *Eisner* v. *Macomber*, 252 U. S. 189 (1920), and as repeatedly applied by this Court in subsequent decisions.

Section 22(a) of the Internal Revenue Code does not purport to include in gross income all receipts or accessions to wealth. It limits the inclusion to income and, although it illustrates the type of thing Congress had in mind, it makes no attempt to define it. Congress left to the courts the interpretation of that term and its application to the myriad of unforeseeable factual situations that might arise. Indeed, for this latter reason, Congress, however alert to avoid possible undue expansion of the grasp of the income tax, could hardly as a practical matter have done otherwise.

What then is income? Economists have differing conceptions, such as the "service-flow" in consumption theory, the "recurrent receipts" theory and "the net addition to economic power" or the so-called "net accretion" theory. For the practical purposes of income taxation, is the meaning of the term "income" to be controlled by any of these economic abstractions? Or is it to be arrived at on a practical, rational basis in keeping with popular concepts of income?

More than thirty-three years ago, in *Eisner* v. *Macomber*, 252 U. S. 189 (1920), this Court faced this problem and laid down a definition expressing its view as to the

underlying concepts. Under this definition, a receipt to constitute income must have been derived from capital or labor or from their combination. Specifically, the Court said: "'Income may be defined as the gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets . . ." These terms, expressing basic principles, are of course to be interpreted broadly. But where it cannot be said that a receipt is the product of the capital of the recipient (or in substitution for such product), or the product of his labor (*i.e.*, the return for some action, effort, service or forbearance on his part), or, in some cases under a specific statutory income tax pattern, the product of the capital or labor of one to whom the recipient bears a special relationship (such as donor and donee or divorced husband and wife), it is not income, even though an accession to wealth results.

So far as we are aware, this Court has never questioned the soundness of this basic concept of the characteristic and distinguishing attributes of income for tax purposes. On the contrary, in other cases since 1920 and indeed as recently as 1952 this Court has repeatedly applied and adhered to the *Eisner* v. *Macomber* concept of income. See *Helvering* v. *Griffiths*, 318 U. S. 371 (1943), in which this Court refused to overrule *Eisner* v. *Macomber; Merchants' Loan & Trust Co.* v. *Smietanka*, 255 U. S. 509 (1921); *Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170 (1926); *Taft* v. *Bowers*, 278 U. S. 470 (1929); *United States* v. *Safety Car Heating Co.*, 297 U. S. 88 (1936); *Commissioner* v. *Culbertson*, 337 U. S. 733 (1949); and *Rutkin* v. *United States*, 343 U. S. 130 (1952). To be sure, in *United States* v. *Kirby Lumber Co.*, 284 U. S. 1 (1931), Mr. Justice HOLMES, speaking for this Court, said in his characteristic way, in referring to the *Eisner* v. *Macomber* definition: "We see nothing to be gained by the discussion of judicial definitions." But the income held to have been

realized in the *Kirby* case resulted from the taxpayer's financial transactions and activities, including the use of its capital, and it could easily have been held to come within the broad meaning of the source language of the *Eisner* v. *Macomber* definition. Indeed, the only court decisions which cannot be justified under the *Eisner* v. *Macomber* income definition are the recent decisions in the Section 16(b) cases.

This Court has never accepted the Commissioner's argument below and in the *Glenshaw Glass* case that all accessions to wealth constitute taxable income unless specifically excepted by statute. Since *Eisner* v. *Macomber*, this Court has specifically held that certain accessions to wealth, not specifically excluded from gross income by Section 22(b) of the Code, do not constitute gross income. *Brown Shoe Co.* v. *Commissioner*, 339 U. S. 583 (1950) (contribution by community group to taxpayer to induce location of plant in community not income); and *Edwards* v. *Cuba R.R. Co.*, 268 U. S. 628 (1925) (subsidy received by taxpayer from Cuban Government to induce railway construction not income).

Since 1922, the Treasury Regulations have combined the definition of gross income included in Section 22(a) of the Code with the above quoted definition of income from *Eisner* v. *Macomber*. (U. S. Treas. Reg. 62, Art. 31, issued under the Revenue Act of 1921; and U. S. Treas. Reg. 111, Sec. 29.22(a)-1 (1943).) During all this period the Treasury Regulations have not been changed in this respect.

There is no evidence so far as we know that Congress is dissatisfied with the *Eisner* v. *Macomber* concept of income. Indeed, the latest evidence indicates the contrary.*

* In the proposed new Revenue Code of 1954, H. R. 8300, 83rd Congress, 2nd Session, it is proposed in Subchapter B, Part II, Section 74, to exclude from gross income amounts received as prizes and awards made primarily in recognition of religious, charitable, educational, artistic, literary or civic achievement if "the recipient was selected without any action on his part" and "is not required to render substantial future services as a condition to receiving the prize or award".

The *Eisner* v. *Macomber* concept has been generally accepted. The Committee on Terminology of the American Institute of Accountants, in commenting upon it, has stated that it conforms closely to the accounting concept and is appropriate for adoption by accountants for general application. See Accounting Research Bulletin No. 9, American Institute of Accountants, May 1941, page 72; Thomas W. Leland, Contemporary Accounting, 1945, Chapter 3, page 1.

With such a consistent, long-standing recognition of the basic characteristics of income for the practical purposes of taxation through repeated reenactments and amendments of the statute, it is submitted that if any change in those characteristics is to be made at this late date it should be done by Congress and not by the courts.

This is not to suggest that this Court should be hidebound by a literal interpretation of its own earlier definition. This Court has of course, since then, developed and refined the law with respect to some aspects of income with which we are not here concerned, namely, with respect to questions of sufficiency of severance, time of realization, claim of right and imputed income. See *e.g.*, *Helvering* v. *Bruun*, 309 U. S. 461 (1940), and *Rutkin* v. *United States*, *supra*. But so far as we are aware, with the exception of the recent Section 16(b) cases, there is no decision of this Court or of any other Court since *Eisner* v. *Macomber* in which a receipt has been held to be income which would not be income under a reasonable interpretation of the source rule, the "capital" and "labor" language, of the *Eisner* v. *Macomber* definition. And we submit that the importance of stability in the highly practical law of taxation should dictate that in so far as the required sources of derivation are concerned no change should be made at this late date in the established meaning of income for tax purposes, at least without some indication of a Congressional desire for a change.

III

The decision below involves an important principle of tax law which ought to be clarified and settled by this Court in the interest of sound and proper application of the internal revenue laws.

There are already indications that the recent decisions in the Section 16(b) cases are inviting administrative attempts to expand the grasp of the income tax so as to apply to receipts never before considered to constitute income.

If the receipts here in question constitute income to the petitioner even though not derived from the petitioner's capital or labor or both, or any action or inaction on its part, it is difficult to see why the accidental finding of treasure-trove would not *a fortiori* constitute income. A finder at least does something and his find is the result of his own free and uncontrolled action. Never until recently in the long history of Federal income taxation has any attempt been made so far as we know to tax the accidental finding of treasure-trove as income. But following his success in the Court of Claims and the Tax Court in the Section 16(b) cases, the Commissioner has recently ruled, contrary to common belief, that the finding of treasure-trove is the receipt of taxable income (no indication being given as to the effect of the finder's rejection of his find). See *Revenue Ruling 61*, 1953—1 C. B. 17.

Where is the dividing line to be drawn between what is and what is not income if it is not drawn essentially along the lines this Court has heretofore indicated? Surely it is not to be drawn haphazardly on a case-by-case basis, as suggested by the Court below, without any guiding rules whatever other than the particular court's hunch as to popular understanding or its notion concerning public policy considerations. The Court below thought it of no

help to talk about "windfalls" or "penalty". But the Court in the *Glenshaw Glass Co.* case said: "We do believe that a 'windfall' . . . would not be regarded as 'income' within the terms of common speech. . . . We believe that the ordinary man regards income as something which comes to him from what he has done, not from something which is done to him." The Court said, further: "A single gift of money or property probably should not be treated as taxable income even if the specific exemption granted to gifts by statute were unavailable." Unless this Court clarifies the important basic principle involved in this case and the *Glenshaw Glass Co.* case, confusion and interminable litigation are likely to ensue.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

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June, 1954.

APPENDIX

Commissioner of Internal Revenue, Petitioner v. *Glenshaw Glass Company, Respondent. Commissioner of Internal Revenue, Petitioner* v. *William Goldman Theatres, Inc., Respondent.*

In the United States Court of Appeals for the Third Circuit. Nos. 11,073, 11,150. April 9, 1954.

Appeals from the Tax Court of the United States.

Before BIGGS, Chief Judge, and MARIS, MCLAUGHLIN, KALODNER, STALEY and HASTIE, Circuit Judges.

OPINION OF THE COURT

BIGGS, Chief Judge: The Commissioner seeks to reverse two decisions of the United States Tax Court in favor of two taxpayers. In Glenshaw a claim for punitive damages based upon a competitor's, Hartford's, fraudulent suits which disastrously affected the taxpayer's business, as well as a claim for treble damages under Section 4 of the Clayton Act, 15 U. S. C. A. § 15, were settled by the payment of a sum of money.[1] In Goldman a judgment for treble damages was awarded Goldman against Loew's, Inc.,[2] also pursuant to Section 4 of the Clayton Act. The sole question presented for our determination is whether moneys paid as punitive or statutory treble damages are taxable as income under Section 22(a) of the Internal Revenue

[1] For the history of the litigation see: *Hartford-Empire Co.* v. *Shawkee Mfg. Co.*, 163 Fed. (2d) 474 (3 Cir. 1947); *Hartford-Empire Co.* v. *Shawkee Mfg. Co.*, 67 Fed. Supp. 26 (D. C. W. D. Pa. 1946); *Hartford-Empire Co.* v. *United States*, 323 U. S. 386 (1945); *Hartford-Empire Co.* v. *Shawkee Mfg. Co.*, 147 Fed. (2d) 532 (3 Cir. 1944); *Shawkee Mfg. Co.* v. *Hartford-Empire Co.*, 322 U. S. 271 (1944), reversing *Hartford-Empire Co.* v. *Shawkee Mfg. Co.*, 137 Fed. (2d) 764 (3 Cir. 1943); *Shawkee Mfg. Co.* v. *Hartford-Empire Co.*, 68 Fed. (2d) 726 (3 Cir. 1934); and *Hartford-Empire Co.* v. *Hazel-Atlas Glass Co.*, 59 Fed. (2d) 399 (3 Cir. 1932).

[2] See *William Goldman Theatres, Inc.* v. *Loew's, Inc.*, 164 Fed. (2d) 1021 (3 Cir. 1948).

Code.[3] The Tax Court has decided that they are not and the Commissioner of Internal Revenue has petitioned this court for review.[4] Insofar as the issue before us is concerned no valid distinctions can be drawn between a money settlement and money paid in satisfaction of a judgment or between punitive damages levied for fraud and treble damages rendered under the Clayton Act.[5]

The positions of the taxpayers are based in large part upon the definition of "income" set out in *Eisner* v. *Macomber*, 252 U. S. 189, 207 (1920), on the decision of this court in *Central R. Co.* v. *Commissioner*, 79 Fed. (2d) 697 (1935), the decision of the Board of Tax Appeals in *Highland Farms Corporation*, 42 B. T. A. 1314 (1940), and the applicable Treasury Regulations.[6,7] The taxpayers also

[3] Section 22(a) of the Internal Revenue Code, in pertinent part, is as follows:

"*General Definition.*—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever . . ."

[4] The Tax Court opinions are reported at 18 T. C. 860 (*Glenshaw*) and 19 T. C. 637 (*Goldman*). See also *Obear Nester Glass Co.*, 20 T. C. No. 152, and *Telefilm, Inc.*, 21 T. C. —, similar cases.

[5] The Commissioner and Glenshaw do not now dispute that $324,529.94 was the amount paid in settlement of punitive damages. In the *Goldman* case the amount of actual damage, found to be $125,000, was trebled and a judgment was entered for $375,000. We are concerned solely with the taxability of the sum of $324,529.94 (*Glenshaw*) and the taxability of $250,000 (*Goldman*).

[6] The facts of the *Central R. Co.* case are distinguishable from those at bar. In the *Central R. Co.* case the taxpayer received property in settlement of a suit brought by it against an unfaithful officer who violated his fiduciary duty to it and thereby deprived the railroad of revenues. A kind of resulting or constructive trust was imposed upon the fruits of his fraud in favor of the railroad company. Nevertheless this court considered the railroad's gain to be a "windfall", not derived either wholly or in part from the taxpayer's capital or labor and therefore not income at all within the definition of *Eisner* v. *Macomber*.

The decision was followed by the Board of Tax Appeals in *Highland Farms Corporation, supra*, where punitive damages were allowed for slander of title to land. The Board of Tax Appeals refused to treat these punitive damages as income, relying also on the test of taxable income set out in *Eisner* v. *Macomber*.

[7] Treasury Regulations 111, in pertinent part provide:

"Sec. 29.22(a)-1. *What Included in Gross Income.*—Gross income includes in general compensation for personal and professional services, business income,

assert considerations which are based on the general philosophy of income taxation but we will not discuss these specifically in this opinion. But the United States for its part contends that *Eisner* v. *Macomber* does not settle the applicable definition of what constitutes taxable income insofar as the cases at bar are concerned, that the decision of this court in the *Central R. Co.* case is not applicable, but if it is, it was wrongly decided, and that the decision of the Board of Tax Appeals in *Highland Farms* was clearly erroneous. The substance of the government's argument is that all property or money coming into the hands of a taxpayer is income except where specifically exempted by the taxing statute.

In *Eisner* v. *Macomber* the Supreme Court stated: "'Income may be defined as a gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through sale or conversion of capital assets . . ." In *Eisner* v. *Macomber* the Supreme Court laid emphasis on the ordinary meaning of income in common parlance and said, 252 U. S. at pp. 206-207: "For the present purpose we require only a clear definition of the term 'income' as used in common speech, in order to determine its meaning in the Amendment . . ." The second sentence of the applicable Treasury Regulations adopted the *Eisner* v. *Macomber* definition *in toto*. See note 7 of this opinion. The only qualification of the second sentence of the regulation lies in the phrase "in general" and surely little can be taken from that. Of course, as the United States points out, in *Eisner* v. *Macomber* the Supreme Court was primarily concerned with distinguishing between capital and income, not between sources of property which came into the hands of the taxpayer and we cannot doubt but that the Supreme Court has departed in

profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (see section 22(b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. . . ."

some degree from the *Eisner* v. *Macomber* definition. This is apparent from *United States* v. *Kirby Lumber Co.*,[8] 284 U. S. 1, 3 (1931) where Mr. Justice Holmes stated: "We see nothing to be gained by the discussion of judicial definitions."

If the property or money paid represents a return of capital or a contribution to capital it is not subject to income taxation. Subsidies paid by a sovereign to aid in the construction and operation of a railroad line were held not to be income in *Edwards* v. *Cuba R. R. Co.*, 268 U. S. 628 (1925) and the money and property acquired were treated in effect as an accretion to capital. But compare *Detroit Edison Company* v. *Commissioner*, 319 U. S. 98 (1943) where the Supreme Court has indicated some halt in the doctrine of capital donation expressed in *Edwards* v. *Cuba R. R. Co.*, *supra*. Cf. also *Great Northern Ry. Co.* v. *Commissioner*, 8 B. T. A. 225 (1927), aff'd 40 Fed. (2d) 372 (8 Cir., 1930). A single gift of money or property probably should not be treated as taxable income even if the specific exemption granted to gifts by statute were unavailable. Periodicity seems to be considered a factor. See *Irwin* v. *Gavit*, 268 U. S. 161, 168 (1925); Magill, *Taxable Income*, *supra*, note 8, at p. 428. The spontaneity of the gift may also serve to relieve the recipient of tax. See *Bogardus* v. *Commissioner*, 302 U. S. 34, 42 (1937), *Washburn* v. *Commissioner*, 5 T. C. 1333 (1945).[9]

The United States lays emphasis on the decision of the Court of Claims in *Park & Tilford Distillers Corp.* v. *United States*, 107 Fed. Supp. 941, 943-5 (1952). In this case the issue was whether a recovery under Section 16(b)

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[8] The lumber company purchased its own bonds in the open market at less than par and the difference in price was held to be taxable as income. It is clear, however, that compensatory damages for loss of income are taxable as income and that income takes its color from source. See Chapter 10 "Compensatory Payments," *Taxable Income*, Magill, Rev. Ed., 1945, at p. 377 *et seq.*

[9] Sums of money won by way of contest awards are taxable. See *Robertson* v. *United States*, 343 U. S. 711 (1952). But these cases are readily distinguishable from a mere gift since services are rendered. Lottery prizes are also distinguishable. See *Huntington* v. *Commissioner*, 35 B. T. A. 835 (1937).

of the Securities Exchange Act, 15 U. S. C. A. § 78p(b), constituted income to the recovering corporate taxpayer. The Court of Claims held that the recovery was taxable as income and specifically rejected the reasoning of this court in *Central R. Co.* v. *Commissioner* and the decision of the Board of Tax Appeals in *Highland Farms*. The Court of Claims stated: "The money came in from an outside source, it went into the plaintiff's treasury, it did not replace something which went out of plaintiff's ownership as a consideration for it." The Court went on to say that it was unwilling to surmise that the definition of "income" of *Eisner* v. *Macomber* was sufficient to read out of the taxing statute the phrase "income derived from any source whatever". In our opinion the theory of recovery under Section 16(b) of the Securities Exchange Act of 1934 is not a purely punitive one. The statute was designed to prohibit profit being made by an "insider" possessing peculiar knowledge of future profitable operations of his corporation. The making of a profit by the "insider" is the mainspring of the statute, a profit required by law to be passed on to the corporation probably because the corporation is the most convenient receptacle. An "outsider" purchasing stock in the open market, theoretically at least, would be compelled to pay a higher price because an insider was purchasing stock in the market against him. But, under the operation of the statute, all of the stockholders, save only the "insider" whose operations were prohibited by statute, would receive via the corporate entity the profit made by the prohibited transaction.[10] We do

[10] The nature of Section 16(b) of the Securities Exchange Act of 1934 is referred to in 66 Harv. L. Rev. at p. 408 as follows:

"We are unaware of any other statute that offers a precise analogy to this subsection. It has within it elements of an ordinary shareholder's derivative suit for damages based upon a breach of fiduciary duty, elements of a statutory action for punitive damages, and elements of an informer's statute. It appears to proceed on the principle that the confidential information which a corporate insider automatically obtains by virtue of his position belongs to the corporation. Having availed himself personally of this information, the insider is made liable to the corporation for the profits he realizes. Unlike the 'corporate opportunity' cases, however, the action may be brought even though the insider has not competed with his corporation in the use of the information. The courts have found each of these analogies useful, but none furnishes compelling authority."

not agree with the position of the Court of Claims that Park & Tilford's recovery was purely a "windfall".

In *General American Investors Company, Inc.* v. *Commissioner*, 19 T. C. 581 (1952), affirmed,—Fed. (2d)—(2d Cir., 1954), the Tax Court followed the *Park & Tilford* decision of the Court of Claims but distinguished its decision from that in the instant *Glenshaw Glass Company* case and the decisions in *Central R. Co.* and *Highland Farms* employing the definition of taxable income of *Eisner* v. *Macomber*. Judge Murdock in his concurring opinion pointed to the provisions of Section 16(b) of the Securities Exchange Act of 1934, viz., that "any profit realized" under the circumstances presented by the *General American Investors* case "shall inure to and be recoverable by the issuer", i. e., the corporation. Judge Murdock took the position that the profits were income to General American Investors within the purview of Section 22(a) of the Internal Revenue Code "since they were 'profits' either from 'sales or dealings in property . . . growing out of the ownership of . . . or interest in such property' or 'from any source whatsoever'."

The facts of the *Park & Tilford* and the *General American Investors* decisions are distinguishable from those at bar and from *Central R. Co.* v. *Commissioner*, *supra*.

The United States contends that the "source of gain" should not be controlling in view of the final phrase of Section 22(a) dealing with gains or profits or income "derived from any source whatever"; that the phrase last quoted expresses congressional intent that the source of income or gain is immaterial—a complete negation of the concept of source in relation to taxable income. The government in substance asserts that any money or property coming into the hands of any person is taxable as income unless specifically exempted. But we have found no case in which the court did not look to source as at least coloring or bearing upon the incidence of taxation.

Punitive damages seem to be *sui generis*. By definition they are not compensatory. They certainly possess no periodicity. They are not derived from capital, from labor or from both combined and assuredly they are not profit gained through the sale or conversion of capital assets. It is clear that they do not fall within the definition of *Eisner* v. *Macomber* and if we could be certain that the definition of that case was controlling we would have no difficulty with the issue at bar. It is easy to say what punitive damages are not but difficult to say what they really are. They smack of donations made to the individual by the State, by operation of law. A person does a prohibited act to another injuring him. The injured individual is subsequently enriched by a gift taken from the pocket of the injuring party by virtue of law. There is no *quid pro quo*. An analogy seems to us to lie in those cases where contributions are made by the sovereign in the general public interest to an individual. Cf. *Edwards* v. *Cuba Railroad Company*, *supra*. Where the injuries were gross, the doctrine of punitive damages comes into play. The taxpayers have recovered because the sovereign has seen fit to punish gross behavior for the good of the public. There are naked exactions by the sovereign which go to the injured corporations rather than to the fisc. There is vague likeness to a fine exacted by the sovereign but which goes to the taxpayer.

The Supreme Court has never expressly departed from the definition of income of *Eisner* v. *Macomber*. In fact it has reiterated it fairly recently. See *Merchants Loan and Trust Company* v. *Smietanka*, 255 U. S. 509, 519 (1921) and *Commissioner* v. *Culbertson*, 337 U. S. 733, 740 (1949). And see *Helvering* v. *Griffiths*, 318 U. S. 371 (1943) in which the Supreme Court expressly declined to overrule *Eisner* v. *Macomber* on the facts there presented. The *Culbertson* decision cites not only Treasury Regulation 101, Article 22(a)-1 but also 1 Mertens, Law of Federal Income Taxation, 159 *et seq.* See the authorities set out in note 9 cited to § 5.02 of Mertens. We concede that no definition

is too helpful, *United States* v. *Kirby Lumber Co., supra,* and that the decisions relating to income tax law contain charts rather than definitions, as Mr. Mertens has aptly stated. But it should be borne in mind that in *Eisner* v. *Macomber,* albeit where severability was the primary issue, the Supreme Court said, 252 U. S. at pp. 206-207, that "only a clear definition of the term 'income' as used in common speech . . ." was required. We do believe that a "windfall"—and the payments at bar were "windfalls"—would not be regarded as "income" within the terms of common speech. Certainly the payments to the taxpayers cannot fairly be regarded as products of capital or labor. We believe that the ordinary man regards income as something which comes to him from what he has done, not from something which is done to him. This is perhaps an over-simplification but we are of the opinion that the ordinary man using terms of common speech would not regard punitive damages as "income."

We must further concede that the decision of this court in *Central R. Co.* v. *Commissioner* cannot be deemed to be overwhelmingly persuasive for the sources of the moneys in that case can be distinguished from the sources of the moneys sought to be taxed in the instant cases but the decision has been followed frequently and has been applied to the issue of taxation of punitive damages. See *Highland Farms, supra.* There is as yet no decision which has adopted the contentions made by the Government here. The position of the United States, would indeed, if adopted, bring symmetry into this aspect of the law of income taxation. See "The Taxability of Punitive Damages," 101 U. of P. L. Rev. 1052 (1953). Cf. *Keasbey and Mattison Co.* v. *Rothensies,* 133 Fed. (2d) 894, 897 (3 Cir., 1943). But we think if such a result is to be achieved after nearly two decades it should be effected by the Supreme Court and not by this tribunal.

The decisions of the Tax Court will be affirmed.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1954

No. 114

GENERAL AMERICAN INVESTORS COMPANY, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1954

No. 114

GENERAL AMERICAN INVESTORS COMPANY, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

Opinion Below

The opinion of the Tax Court (R. 3) is reported at 19 T. C. 581. The opinion of the Court of Appeals (R. 13) is reported at 211 F. 2d 522.

Jurisdiction

The judgment of the Court of Appeals was entered on March 9, 1954 (R. 19-20). The petition for certiorari was filed June 4, 1954 and was granted October 14, 1954 (R. 26).

The jurisdiction of this Court rests upon 28 U. S. C. § 1254 (1) and Section 1141(a) of the Internal Revenue

Code of 1939. See Section 7851(b)(1) of the Internal Revenue Code of 1954.

Question Presented

In 1948, petitioner received $170,038.04 from a director and from a stockholder in satisfaction of liabilities imposed on them by Section 16(b) of the Securities Exchange Act of 1934 as made applicable by Section 30(f) of the Investment Company Act of 1940.

The sole question presented is whether the amount received by petitioner is includible in petitioner's "gross income".

Constitutional Provisions, Statutes and Regulations Involved

The Sixteenth Amendment to the Constitution of the United States:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

Section 22(a) of the Internal Revenue Code of 1939:

> "(a) GENERAL DEFINITION.—'Gross income' includes gains, profits, and income derived, from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property;

also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever . . ."

U. S. Treas. Reg. 111, Sec. 29.22(a)-1:

"*What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22(b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through sale or conversion of capital assets. Profits of citizens, residents, or domestic corporations derived from sales in foreign commerce must be included in their gross income; but special provisions are made for nonresident aliens and foreign corporations by sections 211 to 237 inclusive, and, in certain cases, by section 251, for citizens and domestic corporations deriving income from sources within possessions of the United States. Income may be in the form of cash or property."

Section 30(f) of the Investment Company Act of 1940, 15 U. S. C. § 80a-29(f):

"(f) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of outstanding securities (other than short-term paper) of which a registered closed-end company is the issuer or who is an officer, director, member of an advisory board, investment adviser, or affiliated person of an investment adviser of such a company shall in respect of his transactions in any securities of such company (other than short-term paper) be subject to the same duties and liabilities as those imposed by section 16 of the Securities Exchange Act of 1934 upon certain beneficial owners, directors, and officers in respect of their transactions in certain equity securities."

Section 16(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78p(b):

> "(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

Statement

The pertinent facts, as they were found by the Tax Court (R. 3-6), are as follows:

Petitioner is a registered closed-end investment company as defined in the Investment Company Act of 1940.

On or about April 1, 1944, one of petitioner's directors acquired warrants to purchase shares of petitioner's common stock at five different prices ranging from $10 to $20 per share. On or about the same date, a second individual (referred to as "stockholder"), who at all times between June 5, 1945 and June 17, 1946 owned more than 10% of the then outstanding warrants, also acquired warrants to purchase shares of petitioner's common stock at similar prices.

More than a year and a half after acquisition of the warrants, viz., on December 4 and 18, 1945, the director and the stockholder exercised certain of their warrants and purchased shares of petitioner's common stock at the average purchase price of $13.75 per share. The director exercised warrants to purchase 12,228 shares and the stockholder 28,532 shares. These purchases upon the exercise of warrants were the only purchases of common stock of petitioner by the director and the stockholder from June 5, 1945 to June 17, 1946.

Between June 5, 1945 and June 17, 1946, the first date being more than a year after acquisition of the warrants but both dates being within the period of six months before and six months after the exercise of the warrants, the director, individually and through a partnership of which he was a member, and the stockholder, individually and through a partnership of which he was a member, sold on the New York Stock Exchange 12,228 plus shares and 27,027 shares, respectively, of petitioner's common stock.

Pursuant to Section 30(f) of the Investment Company Act of 1940 and Section 16(b) of the Securities Exchange Act of 1934, the director and the stockholder were required to pay to petitioner certain "profits", as that term is used in the Securities Exchange Act of 1934, realized upon the sales and purchases, or purchases and sales, of shares of petitioner's common stock between June 5, 1945 and June 17, 1946, inclusive. The "profits" were computed by subtracting from the highest amounts realized by the director and

the stockholder on their sales of the stock the average amounts the director and the stockholder had paid to petitioner on the exercise of the warrants plus the average cost of the warrants themselves. The "profits" were paid by the director and the stockholder to petitioner upon the advice of counsel and without litigation.

The "profit" required to be paid petitioner by the stockholder as a result of such transactions was computed to be $129,362.95, and the "profit" required to be paid petitioner by the director as a result of such transactions was computed to be $81,092.33. The director paid petitioner $40,417.24 on March 9, 1946, and he paid his remaining $40,675.09 and the stockholder paid his entire $129,362.95, which together total $170,038.04, to petitioner in 1948.

Of the proceeds received by petitioner upon the exercise of the warrants, petitioner credited $1 per share to its capital account and the balance to its capital surplus account. The $40,417.24 received from the director in 1946 was in that year credited to petitioner's capital surplus account. The amounts received from the director and stockholder in 1948 were recorded by petitioner in its cash book as "Capital Surplus—add'l amt recd in connection with common stock issued in 1945", and the aggregate amount so received in 1948 was credited to petitioner's capital surplus account. Thereafter, upon notification by respondent that these 1948 receipts should be returned as income, petitioner debited capital surplus account and credited a receipts-in-suspense account with these amounts and thereafter, at the close of 1948, debited the latter account with a reserve for taxes and legal expenses and transferred the balance to capital surplus.

The Tax Court held, with one judge dissenting, that the $170,038.04 received by petitioner in 1948 from the director and the stockholder was gross income to petitioner, against which petitioner was allowed to deduct an expense of $13,000 incurred as legal fees in recovering that amount.

The decision of the Tax Court was affirmed by the Court of Appeals for the Second Circuit.

Summary of Argument

We do not urge that this Court should be bound by a narrow interpretation of its own prior definition of income. We do urge that the Court adhere to the historical concept of the nature and distinguishing characteristics of income which it long ago adopted and has repeatedly followed and from which it has never departed. Under that concept, which is much broader than the concept of income for tax purposes in Great Britain and Canada, receipts or accessions to wealth are not income unless in a basic generic sense they are derived from or are attributable to some act or effort (labor) or some asset (capital) of the taxpayer or a combination of the two.

Under this historical concept, the receipt here in question is not income. The suggestion, rejected by the Court below, that it is in the nature of income because Section 16(b) of the Securities Exchange Act of 1934 characterizes it as a "profit" "realized" by the "insider" which is to "inure" to the corporation, will not stand analysis. The taxation as income of the receipt here involved cannot be reconciled with the nontaxation of punitive or treble damage recoveries. If receipts of the latter sort do not constitute income, then *a fortiori* the receipt here involved is not income, although the reverse does not necessarily follow.

The broad conceptual dividing line heretofore drawn by this Court is the only rational line that can be drawn between what is and what is not income for tax purposes. Unless this Court here adheres to the historical dividing line, it would logically follow either that there is no guiding rule whatsoever for the determination of income other than a judicial "hunch" as to common understanding or public policy considerations or that, contrary to common under-

standing and to many decisions of this Court and other Courts, Congress would have the untrammeled power to tax as income every realized enrichment even though it be received as a gift, or as a contribution to capital, or as a bequest, devise or inheritance, or as the result of a canceled stock subscription, or as treasure-trove accidentally found, or as an unforeseen and unsought for windfall of any kind whether or not forced upon the recipient by law for the purpose of penalizing another. It is submitted that receipts of such unusual character are not and have not been commonly thought to be income for tax purposes and, though Congress may subject them to excise or transfer taxation, as it does with respect to gifts and estates, it neither has subjected them nor may it subject them to income taxation under an income tax statute. Ample room remains for the operation of the income tax in the income area already broadly expanded to include all receipts from business or personal activities in pursuit of gain or derived from capital or in return for almost any consideration whatsoever.

ARGUMENT

I.

A payment received by a corporation pursuant to Section 30(f) of the Investment Company Act of 1940 and Section 16(b) of the Securities Exchange Act of 1934 is not income to the corporation.

In the following cases in addition to the present one, the receipt of a Section 16(b) payment has been held to constitute income to the corporate recipient. *Park & Tilford Distillers Corp.* v. *United States*, 107 F. Supp. 941 (Ct. Cl. 1952), cert. denied 345 U. S. 917 (1953); and *Noma Electric Corp.*, 12 T. C. M. 1 (1953), on appeal to the Court of Appeals for the Second Circuit.

On the other hand, the Court of Appeals for the Third Circuit has held that punitive or treble damage recoveries under the antitrust laws are not income, *Commissioner* v. *Glenshaw Glass Company* and *Commissioner* v. *William Goldman Theatres, Inc.*, 211 F. 2d 928 (3rd Cir. 1954), affirming 18 T. C. 860 (1952) and 19 T. C. 637 (1953), whereas the Court of Appeals for the Seventh Circuit has held the contrary. *Commissioner* v. *Obear-Nester Glass Company*, —— F. 2d —— (7th Cir., Nov. 15, 1954), 1954 CCH Fed. Tax Reporter, ¶ 9675, reversing 20 T. C. 1102 (1953). This Court has granted the petition for certiorari in the *Glenshaw Glass* case (Oct. Term, 1954, No. 199); a petition for certiorari has been filed in the *Obear-Nester* case (Oct. Term, 1954, No. 478).

While the Tax Court and the Courts of Appeals for the Second and Third Circuits indicated in these decisions that the foregoing two types of cases might be distinguishable, each attempted to distinguish or indicated the possibility of distinguishing the case in the other Court on grounds which the other Court either expressly rejected or failed to recognize. The Court of Claims and the Court of Appeals for the Seventh Circuit, on the other hand, thought that taxability of Section 16(b) payments cannot be reconciled with nontaxability of punitive or treble damage recoveries.

A. *The nature of a Section 16(b) payment.* Petitioner, acting under compulsion of Section 16(b) of the Securities Exchange Act of 1934 as made applicable by Section 30(f) of the Investment Company Act of 1950,[1] received sums of money from a director and a 10% stockholder. Petitioner did not obtain these receipts in pursuit of any gain. It did not expect them. It had no control over the circumstances

[1] For the purpose of this brief the liability imposed by Section 30(f) of the Investment Company Act of 1940 and the liability imposed by Section 16(b) of the Securities Exchange Act of 1934 will be considered the same, and the phrases "Section 16(b) liability" or "Section 16(b) payment" when used herein is intended to refer to liability or payment under either or both of said sections, whichever is appropriate.

which led to the receipts. It gave nothing whatsoever in return. No effort or activity on its part generated the receipts. It was in legal effect forced to accept the payments irrespective of its own wishes or conduct. It could not waive, reject or return the money because any one of its stockholders could compel it to receive the money willy-nilly. There was no periodicity about the receipts. The receipts had no relation to petitioner's property or its business activity or to any act or promise or undertaking or forbearance on its part. The receipts were not in substitution for or in replacement of any corporate loss of profits or property resulting from wrongful use of petitioner's assets, opportunities or rights or otherwise, such as are dealt with in some cases. *Arcadia Refining Co.* v. *Commissioner,* 118 F. 2d 1010 (5th Cir. 1941); *Raytheon Production Corp.* v. *Commissioner,* 144 F. 2d 110 (1st Cir. 1944), cert. denied 323 U. S. 779 (1944); *Durkee* v. *Commissioner,* 162 F. 2d 184 (6th Cir. 1947). Nor were they obtained for any consideration whatsoever, such as the release of claimed rights or otherwise, as has been involved in certain other cases. *Sterling* v. *Commissioner,* 93 F. 2d 304 (2d Cir. 1937), cert. denied 303 U. S. 663 (1938); *Lyeth* v. *Hoey,* 96 F. 2d 141 (2d Cir. 1938), rev'd on other grounds, 305 U. S. 188 (1938); *White* v. *Thomas,* 116 F. 2d 147 (5th Cir. 1940), cert. denied 313 U. S. 581 (1941).

Petitioner received the money because Congress, interested as a matter of public policy in deterring possible injury to stockholders through misuse by insiders of inside information, decided to penalize the insider who purchases and sells or sells and purchases equity securities of his corporation within six months by depriving him of any "profit" he might realize therefrom, wholly without reference to whether any inside information was used and even without reference to whether the so-called "profit" is really attributable, in a case such as this, to appreciation in value of stock purchase warrants held for a period considerably longer than six months. Congress might have required the so-called "profit" to be forfeited to the Fed-

eral Government or it could have required the forfeited amounts to be distributed among the stockholders for whose protection the provision was enacted. It chose, however, the more convenient course of requiring the forfeited amounts to be paid to the corporation, thus indirectly benefiting all stockholders, and gave the stockholders a right to enforce collection if the corporation failed to do so. In a real sense and in economic effect, from the standpoint of the corporate recipient they resemble legally enforced capital contributions for the benefit of the stockholders. From the standpoint of the insider, the amounts in question were penalties, *Smolowe* v. *Delendo Corp.*, 136 F. 2d 231 (2d Cir. 1943), cert. denied 320 U. S. 751 (1943), which the insider could not deduct from gross income for Federal income tax purposes. *William F. Davis, Jr.*, 17 T. C. 549 (1951); *W. L. Dempsey*, 10 T. C. M. 936 (1951). In any event, the circumstances giving rise to the obligation to pay and receive were entirely beyond petitioner's contemplation or control, and the payments received did not represent compensation for any injury inflicted on it or a restitution of profit from wrongful use of its assets, opportunities or rights. In short, they had nothing whatsoever to do with its property or its labor or any action or inaction of any kind on its part.

In the present case the only purchases by the insiders were made directly from the corporation upon the exercise of warrants; there were no purchases in the open market (R. 4-5). When the insiders made sales resulting in Section 16(b) liability, the economic effect was to increase their cost of the shares acquired upon exercise of the warrants and, by the same token, to increase the subscription price received by the corporation for the stock. The corporation credited the amounts received to capital surplus accordingly (R. 5-6). In essence, therefore, the corporate receipt was very much akin to the receipt of part of the subscription price of newly issued shares—which is not

income. Treas. Reg. 111, Sec. 29.22(a)-15. Whether or not the requirement of Section 16(b) can be said to be part of the subscription contract (*cf. Hutchison* v. *Ward*, 114 N. Y. App. Div. 156, 158, 99 N. Y. Supp. 708, 709 (1st Dept. 1906)), it would seem especially appropriate to treat the character of the Section 16(b) payment in this case as no less capital in nature than a corresponding adjustment of the subscription price would have been had the subscription contract itself expressly required the payment.

B. *The taxability of a Section 16(b) payment cannot be reconciled with the nontaxability of punitive or treble damage recoveries.* The Court below, affirming the Tax Court, held that the sums received by petitioner constituted income within the meaning of Section 22(a) of the Internal Revenue Code. The Court's reasoning was in substance that there is no common principle or touchstone by the application of which one may infallibly determine what is and what is not income in a given case; that an empirical case-by-case approach must be adopted; that no considerations of policy affect the case one way or the other since the purpose of Section 16(b) will be served equally well whether or not the payments are held to be income to the recipient corporation; that, taking the words "gains or profits and income from any source" in their plain, popular meaning, the Section 16(b) payments constituted income—the petitioner having unrestricted discretion to use the funds for any purpose whatsoever and they being in no sense donations or contributions to capital, payments by way of restoration of lost capital or compensation for any loss suffered by petitioner.

With regard to the cases holding punitive and treble damage recoveries not income, the Court said policy considerations may in the end there play a decisive or persuasive role; but the Court refused to express any opinion thereon, pointing out that such policy considerations may perhaps have no relevance and the Court of Claims may be

right in the *Park & Tilford Distillers* case in saying those cases were wrongly decided.

In holding that punitive and treble damage receipts over and above actual damages do not constitute income, the Court of Appeals for the Third Circuit, in *Glenshaw Glass*, rejected the government's argument that all money or property coming into a person's hands is taxable as income unless specifically exempted by statute, saying it had found no case in which the Court did not look to source as at least coloring or bearing upon the incidence of taxation. Paying considerable allegiance to this Court's historical definition of income and to the requirement that "income" be interpreted as used in common speech, the Court said that the payments to the taxpayers in the cases before it could not fairly be regarded as products of capital or labor and that in the Court's view the ordinary man regards income as something which comes to him from what he has done, not from something which is done to him, and would not regard punitive damages, a mere windfall, as income. Though the Court said punitive damages seem to be *sui generis*, its reasons for holding them not to be income are strikingly applicable to a Section 16(b) payment also. It made the following points in favor of nontaxability of punitive damages (211 F. 2d at 933):

"By definition they are not compensatory." It can equally be said that a Section 16(b) payment is not compensatory.

"They certainly possess no periodicity." This is true also of a Section 16(b) payment.

"They are not derived from capital, from labor or from both combined and assuredly they are not profit gained through the sale or conversion of capital assets." This too is equally true of a Section 16(b) payment.

Punitive damages "smack of donations made to the individual by the State, by operation of law. A person does

a prohibited act to another injuring him. The injured individual is subsequently enriched by a gift taken from the pocket of the injuring party by virtue of law. There is no *quid pro quo*. An analogy seems to us to lie in those cases where contributions are made by the sovereign in the general public interest to an individual. . . . The taxpayers have recovered because the sovereign has seen fit to punish gross behavior for the good of the public. There are naked exactions by the sovereign which go to the injured corporations rather than to the fisc. There is vague likeness to a fine exacted by the sovereign but which goes to the taxpayer." This reasoning is applicable *a fortiori* to a Section 16(b) payment, for in such case, unlike the treble damage case, no injury to any corporate interest need be shown; a class of behavior is punished as gross even though no specific injury occurs. Of course, the corporate recipient of a Section 16(b) payment may in some situations be injured by the insider's actions through impairment of stockholder relations and damage to good will. But the payments in both cases are dictated by the sovereign and in the punitive and treble damage cases are above and beyond any injury.

It is submitted, therefore, that there is no rational basis upon which Section 16(b) payments can be held to be income and punitive damages held not to be income.

C. *Invalidity of attempted distinction based on the language of Section 16(b).* The Court of Appeals in *Glenshaw Glass*, placing particular emphasis upon the concurring opinion of the Tax Court in the present case (R. 11-12), attempted to distinguish the present case on the ground that the making of a profit by the insider is the mainspring of Section 16(b) and that under the operation of the statute, which provides that any "profit realized" by an insider shall "inure to" the issuer, all the stockholders receive via the corporate entity the profit made by the prohibited transaction. However, the Court below in the present case and the Court of Appeals for the Seventh Circuit in the

recently decided *Obear-Nester* case held that such reasoning will not bear analysis. And with this the Commissioner has indicated his accord.[2]

This is clearly correct. Section 16(b) in referring to "any profit realized" speaks of profit realized by the insider; it is the insider's profit which the statute says "shall inure to and be recoverable by" the issuer. Simply because an item represents profit to one person, it does not follow that it also represents a profit to another to whom the law requires the first person to pay it over. The provision that the insider's profit shall inure to the corporation is simply a device to insure that he shall not derive economic advantage from short-term transactions. While profits technically received by one person may be imputed to another in appropriate circumstances under the doctrine of such cases as *Lucas* v. *Earl,* 281 U. S. 111 (1930), *Helvering* v. *Clifford,* 309 U. S. 331 (1940), and *Helvering* v. *Horst,* 311 U. S. 112 (1940), it is implicit in the cases that the income is taxable only to the person to whom it is imputed and not to the recipient as well.

In the Section 16(b) cases, respondent insists that the insider is taxable on any gain realized in connection with his security transactions, even though the transactions give rise to liability under Section 16(b), *I. T. 4069,* 1952-1 C. B. 28, and the insider cannot deduct the Section 16(b) payment for income tax purposes since it is a penalty. *William F. Davis, supra.* It is fundamentally inconsistent to tax the so-called "profit" to the insider and at the same time to tax it to the petitioner because the statute says it shall "inure" to petitioner.

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[2] In footnote 10, page 30, of his brief on appeal in the *Obear-Nester* case, the Commissioner said: "The distinction drawn by the Third Circuit seems to be that under the statute involved in the *Park & Tilford Distillers Corp.* and *General American Inv. Co.* cases the profits were required to be passed on, and inured, to the corporation. But as the Second Circuit stated in its *General American Inv. Co.* decision, such reasoning 'will not bear analysis,' for the 'payments were not "profits" to *petitioner,* although they represented "profits" realized by the director and the stockholder' (italics supplied). (P. 524.) Obviously, the payments were just as much a windfall to the *taxpayer-corporation* as were the punitive damages in the present case."

Moreover, the amount of "profit realized" by the insider for the purpose of Section 16(b) has no necessary relation to the amount of profit, if any, realized by the insider for income tax purposes. The former is arrived at by calculating the maximum "profit" that can be calculated without regard to the profit or loss on the particular stock sold and is not limited to the profit, if any, actually realized as determined under the income tax law. The amount of a Section 16(b) payment is measured under the statute by the excess of the highest sales prices of shares sold during a six months' period over the lowest purchase prices of shares purchased during such period, without regard to the identity of the shares or certificates purchased or sold and without regard to intervening loss transactions. See *Smolowe* v. *Delendo Corp., supra.* In other words, it is a theoretically computed figure having no relation to any actual or taxable gain or loss of the insider. The insider may have suffered a capital loss for tax purposes and have a profit payable to the corporation under Section 16(b). Thus, for example, suppose an insider owns stock purchased years ago at $100 per share. The market steadily declines. He sells his shares at $75, taking a tax loss of $25 per share. Five months later he repurchases an equivalent number of shares at $50 per share. His tax loss is not affected, but he must pay the corporation $25 per share under Section 16(b),—and this notwithstanding that all information available to him and affecting his action was public knowledge and notwithstanding further that he realized no income whatsoever within the meaning of the tax laws. It therefore seems wholly fallacious, in determining the status to the recipient of a Section 16(b) payment, to be influenced by the fact that a so-called "profit realized" by the insider is referred to as the measure of the amount he is required to pay over to the issuer.

Finally, if it be said that a Section 16(b) payment should be income to the recipient corporation simply because the statute says it is a "profit realized" by the in-

sider that the corporation to which it "inures" must pay tax upon, the nature of the income in the hands of the corporation should be the same as in the hands of the insider who realized it. If it was a long-term capital gain to him, it should be the same to the corporation. But this is not what is being attempted nor would it be a feasible approach for the reasons above given.

Whether or not a Section 16(b) payment constitutes income to the corporate recipient accordingly depends, as in the punitive damage cases, upon what is meant by income for Federal income tax purposes.

D. *The meaning of income for Federal income tax purposes.* Section 22(a) of the Internal Revenue Code defines gross income to include:

> ". . . gains, profits and income derived from salaries, wages or compensation for personal service . . . businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from . . . securities, or the transaction of any business carried on for gain or profit, *or gains or profits and income derived from any source whatever.*" (Emphasis supplied.)

Since 1867 taxable income has been defined by statute in substance to include "gains or profits and income derived from any source whatever". See Internal Revenue Act of 1867, 14 Stat. 477. This part of the definition survived the Sixteenth Amendment, adopted in 1913, which gave Congress the "power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States".

Section 22(a) does not purport to include in gross income all receipts or accessions to wealth. It limits the inclusion to income and, although it illustrates by sources the type of thing Congress had in mind, it makes no attempt

to define income. Congress left to the courts the interpretation of that term and its application to the myriad of unforeseeable factual situations that might arise.

What then is income? Economists have differing conceptions, such as the "service-flow" in consumption theory, the "recurrent receipts" theory and "the net addition to economic power" or the so-called "net accretion" theory. For the practical purposes of income taxation, is the meaning of the term "income" to be controlled by any of these differing economic abstractions? Or is it not rather to be arrived at one on some rational basis in keeping with popular concepts of income?

In Great Britain, where use of an income tax far antedated its use in the United States, the tax has been historically imposed on a schedular basis according to sources and there, as in Canada where the schedular system is not followed, taxable income does not include all realizable wealth which in a physical sense comes in; its meaning is limited to include only amounts arising or resulting from the pursuit of gain. La Brie, *The Meaning of Income in the Law of Income Tax* (University of Toronto Press), 1952, p. 21. Windfalls and other enrichments—even capital conversions—not obtained in the pursuit of gain are not regarded as income. *Cf., e.g., Income Tax Commissioner, Bengal* v. *Shaw, Wallace & Co.*, [1932] I. L. R. 59 Calc. 1343, 1350, P. C.; *Ryall* v. *Hoare*, [1923] 2 K. B. 447, 454; *Graham* v. *Green*, [1925] 2 K. B. 37; *Bengon* v. *Thorpe*, [1928] 14 Tax Cas. 1, 13.

In the United States, this Court has had occasion several times, both before and after adoption of the Sixteenth Amendment, to consider the meaning of income for tax purposes. In *Stratton's Independence* v. *Howbert*, 231 U. S. 399 (1913), which involved the 1909 corporation excise tax based on income received from all sources, this Court defined income (p. 415) as "the gain derived from capital,

from labor, or from both combined. . . ." This same definition was adopted in *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, 185 (1918), in determining the treatment of the proceeds of sale of capital assets under the 1909 excise tax act. And in *Eisner* v. *Macomber*, 252 U. S. 189 (1920), this Court again faced the problem and adopted the earlier definition, adding to it the words "provided it be understood to include profit gained through sale or conversion of capital assets". In *Merchants' Loan & Trust Company* v. *Smietanka*, 255 U. S. 509 (1921), involving applicability of the 1916 income tax act to gain realized by a trustee upon sale of assets received from a decedent, the Court reviewed the preceding holdings and said (p. 519):

> "In determining the definition of the word 'income' thus arrived at, this court has consistently refused to enter into the refinements of lexicographers or economists and has approved, in the definitions quoted, what it is believed to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the Constitution. . . . Notwithstanding the full argument heard in this case and in the series of cases now under consideration we continue entirely satisfied with that definition. . . ."

Under the foregoing definition, a receipt to constitute income must have been derived from capital or labor or from their combination. These terms, expressing basic concepts, are of course to be interpreted broadly. But where it cannot be said that a receipt is the product of the capital of the taxpayer (or in lieu of such product, as in the case of discount of rentals to which a property owner is entitled), or the product of his labor (*i.e.*, the return for some action, effort, service, forbearance or other consideration on his part), it is not income, even though an accession to wealth results.[3]

[3] In some cases, but only under a specific statutory income tax pattern, there may be in effect a shifting of tax on the product of the capital or labor

This is a profoundly perceptive definition. An income tax is not a tax on increases in wealth however occurring. Nor is the income tax to be read as if it were the only means by which our government can or has sought to raise revenues. It is, taken at its most comprehensive, a tax upon a particular mode by which increase in wealth occurs. Other taxes, such as those on gifts and estates, the excises on sales, reach other modes in which economic increments occur. Ingenuity has not yet suggested a better definitional base for the income tax than that reflected in this Court's historical definition not only because it defines income in socially significant and empirically satisfactory terms but also because there is no evident stopping point beyond that definition short of taxing any increase in wealth however occurring.

So far as we are aware, this Court has never questioned the soundness of this basic concept of the characteristic and distinguishing attributes of income for tax purposes. On the contrary, in other cases and indeed as recently as 1952 this Court has repeatedly applied and adhered to this historical concept of income. See *Helvering* v. *Griffiths*, 318 U. S. 371 (1943), in which this Court refused to overrule *Eisner* v. *Macomber; Merchants' Loan & Trust Co.* v. *Smietanka, supra; Bowers* v. *Kerbaugh-Empire Co.*, 271 U. S. 170 (1926); *Taft* v. *Bowers*, 278 U. S. 470 (1929); *United States* v. *Safety Car Heating Co.*, 297 U. S. 88 (1936); *Commissioner* v. *Culbertson*, 337 U. S. 733 (1949); and *Rutkin* v. *United States*, 343 U. S. 130 (1952). To be sure, in *United States* v. *Kirby Lumber Co.*, 284 U. S. 1 (1931), Mr. Justice HOLMES, speaking for this Court, said in his characteristic way, in referring to the historic defini-

---

between persons having a special relationship such as the relationship of donor and donee. *Taft* v. *Bowers*, 278 U. S. 470 (1929). It is unsettled whether or to what extent such shifting may occur where the relationship is that of divorced husband and wife. *Cf. Gould* v. *Gould*, 245 U. S. 151 (1917); *Douglas* v. *Willcuts*, 296 U. S. 1, 9 (1935); and *Daisy M. Twinam*, 22 T. C. 83 (1954).

tion: "We see nothing to be gained by the discussion of judicial definitions." But the income held to have been realized in the *Kirby* case resulted from the taxpayer's financial transactions and activities deliberately undertaken, involving the use of its capital, and it could easily be held to come within the broad meaning of the source language of the historical definition. Indeed, the only court decisions which cannot be justified under this definition are the recent decisions holding Section 16(b) payments and punitive damages to be taxable income.

This Court has never embraced the idea that all accessions to wealth constitute taxable income unless specifically excepted by statute. On the contrary, this Court has specifically held that certain accessions to wealth, not specifically excluded from gross income by Section 22(b) of the Code, do not constitute gross income. *Brown Shoe Co.* v. *Commissioner*, 339 U. S. 583 (1950) (contribution by community group to taxpayer to induce location of plant in community not income); and *Edwards* v. *Cuba R.R. Co.*, 268 U. S. 628 (1925) (subsidy received by taxpayer from Cuban Government to induce railway construction not income). *Cf.* also, *Commissioner* v. *Inland Finance Co.*, 63 F. 2d 886 (9th Cir. 1933) (forfeited stock subscriptions not income to the corporation); and *E. H. Clark*, 40 B. T. A. 333 (1939) (receipt by taxpayer of an amount from his tax counsel as compensation for loss suffered on account of erroneous tax advice given taxpayer not income).

Since 1922, the Treasury Regulations have combined the definition of gross income included in Section 22(a) of the Code with the historic definition of income as expanded in *Eisner* v. *Macomber*. (U. S. Treas. Reg. 62, Art. 31, issued under the Revenue Act of 1921; and U. S. Treas. Reg. 111, Sec. 29.22(a)-1 (1943).) During all this period the Treasury Regulations have not been changed in this respect. There is no evidence so far as we know that Congress

is dissatisfied with this historical concept of income. Indeed, the latest evidence indicates the contrary.[4]

This historic concept has been generally accepted. The Committee on Terminology of the American Institute of Accountants, in commenting upon it, has stated that it conforms closely to the accounting concept and is appropriate for adoption by accountants for general application. See *Accounting Research Bulletin No. 9,* American Institute of Accountants, May 1941, p. 72; Thomas W. Leland, *Contemporary Accounting,* 1945, Chapter 3, p. 1. With such a consistent, long-standing recognition of the basic characteristics of income for the practical purposes of taxation through repeated reenactments and amendments of the statute, it is submitted that if any change in those characteristics is to be made at this late date it should be proposed by Congress and not by the courts.

We need not here dispute either the notion that the Congress could tax accessions to wealth that are not income but are "gains" or the notion that Section 22(a) of the Internal Revenue Code represents the exercise by Congress of the full measure of its constitutional authority to impose a tax upon income. For Congress has not attempted to tax anything except income and has not sought to include in gross income any item which by its nature is not income, and, as we contend, a Section 16(b) payment is not income to the recipient. Yet there is a lurking question whether there is not a borderline area in which the Court could say that, though the nature of an item may be in doubt, its belated inclusion in an income tax would be so unusual that Congress should expressly state in the statute that it really desires the item to be taxed. *Cf. Helvering* v. *Griffiths, supra; United States* v. *Supplee-Biddle Hardware Co.,* 265 U. S. 189, 195 (1924); and *cf.* also *Towne* v. *Eisner,* 245 U. S. 418, 425 (1918),

[4] In the Internal Revenue Code of 1954, in Subchapter B, Part II, Section 74, Congress deliberately excluded from gross income amounts received as prizes and awards made primarily in recognition of religious, charitable, educational, artistic, literary or civic achievement if "the recipient was selected without any action on his part" and "is not required to render substantial future services as a condition to receiving the prize or award".

in which Mr. Justice HOLMES, in considering the meaning of income under the 1913 Revenue Act, said that "it is not necessarily true that income means the same thing in the Constitution and the act."

We do not mean to suggest in what has been said that this Court should be hidebound by a literal interpretation of its own earlier definition. This Court has of course, since adoption of the definition, wisely developed and refined the law with respect to some aspects of income with which we are not here concerned, namely, with respect to questions of sufficiency of severance, time of realization, claim of right and imputed income. See *e. g., Helvering* v. *Bruun,* 309 U. S. 461 (1940), and *Rutkin* v. *United States, supra.* But so far as we are aware, with the exception of the recent Section 16(b) and punitive damage cases, there is no decision of this Court or of any other Court in which a receipt has been held to be income which would not be income under a reasonable interpretation of the source rule, the "capital" and "labor" language, of the historical definition. And we submit that the importance of stability in the highly practical law of taxation should dictate that in so far as the required sources of derivation are concerned no change should be made at this late date in the established meaning of income for tax purposes, at least without some indication of a Congressional desire for a change.

E. *The only rational dividing line between what is and what is not income for Federal income tax purposes is essentially the line which this Court has heretofore drawn. The arguments for departing therefrom given by the Court below and the Courts in the* Obear-Nester *and* Park & Tilford *cases prove too much.* Where is the dividing line to be drawn between what is and what is not income for Federal income tax purposes if it is not drawn essentially along the lines this Court has heretofore indicated?

Surely it is not to be drawn haphazardly on a case-by-case basis, as suggested by the Court below, without any

rational guiding rules whatever other than the particular court's hunch as to popular understanding or its notion concerning public policy considerations. The only ground given by the Court below for holding the Section 16(b) payment taxable was based less on reason than on feeling. Having cast off historical restrictions and having observed that "Policy considerations may in the end play a decisive or persuasive role in the punitive damage . . . cases" (R. 15), the Court explained its conclusion by saying (R. 17):

> "So now, if we consider the words 'gains or profits and income from any source,' 'in their plain popular meaning,' as we think they should be, how can there be any doubt that these Section 16(b) payments are 'income'?
>
> "Petitioner had unrestricted discretion to use the funds for any purpose whatsoever; they were in no sense donations or contributions to capital, or payments by way of restoration of lost capital, or compensation for any loss suffered by petitioner."

Under this language, unless some judicial hunch as to policy considerations should dictate otherwise, any receipt of unrestricted funds not falling within the indicated exceptions would constitute income. Yet is there not real doubt, taking the statutory words in their "plain popular meaning", that all such enrichments should be considered income? The Court below thought it of no help to talk about "windfall" or "penalty" (R. 16). But as the Court said in the *Glenshaw Glass* case (211 F. 2d at 933): "We do believe that a 'windfall' . . . would not be regarded as 'income' within the terms of common speech. . . . We believe that the ordinary man regards income as something which comes to him from what he has done, not from something which is done to him." The latter Court said, further (211 F. 2d at 931); "A single gift of money or property probably should not be treated as taxable income even if the specific exemption granted to gifts by statute were unavailable." Indeed, gifts and inheritances have

never before been seriously thought of as income. *Cf. Helvering* v. *American Dental Co.*, 318 U. S. 322 (1943) and *Bogardus* v. *Commissioner*, 302 U. S. 34 (1937). The fact that the statute expressly excludes gifts, bequests, devises and inheritances from gross income is not significant, for the statute also excludes a series of other receipts that are also generally thought to be classifiable in whole or in part as capital rather than as income. Thus there are excluded, for example, in addition to gifts, bequests, devises and inheritances, amounts received under a life insurance contract paid by reason of the death of the insured, a considerable portion of annuity payments, and compensation for personal injuries or sickness.

The Court in the *Obear-Nester* case went even further than the Court below in the present case. Agreeing in general with the views expressed by the Court of Claims in the *Park & Tilford* case, it concluded that Section 16(b) payments and punitive damages should both be considered income for these reasons:

(i) the income tax is based upon ability to pay;

(ii) there is no rational connection between the sources of a taxpayer's gain and his ability to pay—the question is whether he has realized an economic gain from whatever source which leaves him better able to contribute to the support of the government;

(iii) the reason gains from some sources are not taxable is not that they do not constitute income but rather that the Constitution or Congress forbids the collection of tax upon income from these particular sources;

(iv) if gain not derived from capital or labor is excluded from taxation, the burden on income derived from these sources will be all the greater; and

(v) if Congress were to select one kind of receipt of money which above all others would be a fair mark for taxation it might well be windfalls.

The Court, though speaking of "gain", does not in fact define that term; but the term obviously cannot have been intended to include anything that is not income within the meaning of the Sixteenth Amendment. The Court in effect says that every receipt of every kind in money or its equivalent which increases ability to pay constitutes income, and that under the Sixteenth Amendment there may be taxed as income, without apportionment, all gifts, all contributions to capital, all forfeited stock subscriptions, all inheritances, all windfalls and all other realized accessions to wealth whether fortuitous, accidental or otherwise. Yet the only reasons the Court gives for this conclusion are reasons that are no less applicable to a capital levy than to an income tax. Ownership of capital affects ability to pay taxes no less than income; there is no rational connection between the sources of a taxpayer's assets and his ability to pay. Naturally, if capital assets and capital accretions are not taxed, the tax burden on income must necessarily be greater. If Congress were to consider windfalls a fair mark for taxation above all other receipts, it does not follow that they can or should be taxed as income. There is, indeed, no basis for assuming Congress would not have specifically exempted from income tax windfalls and penalties along with gifts and inheritances if it had thought of them.

The points made by the Court in support of its conclusion therefore beg the question and are beside the point. They may bear upon the nether limit of the sheer and absolute power of a sovereign to tax but they shed no light on the nature of an income tax. The Court's view of what constitutes income goes far beyond historical conceptions in this country and in England and Canada, is inconsistent with prior decisions of this Court and is not in accord, it is submitted, with the common understanding of the meaning of

income. If we are correct in believing that the ordinary taxpayer would not think of every personal economic enrichment that comes to him without consideration or effort as income, the adoption of such a notion for purposes of a self-assessing income tax would be not only unwarranted but unwise. How many people would conceive it possible, for example, that Congress could if it wished impose an income tax, as distinct from an inheritance tax, on their receipt of property by bequest, devise or inheritance?

The grasp of the income tax is properly very broad—broader in the United States than in Great Britain or in our English-speaking neighbor, Canada. But in the popular mind, we submit, it does not reach and subject to progressive income taxation, at the whim of Congress, such types of receipts as gifts, bequests, devises and inheritances, forfeited stock subscriptions, windfalls and penalties of the character under consideration here and other windfalls including treasure-trove accidentally found. Never until recently in the long history of Federal income taxation has any attempt been made so far as we know to tax the accidental finding of treasure-trove as income. But following his success in the Court of Claims and the Tax Court in the Section 16(b) cases, the Commissioner ruled, contrary it is submitted to common belief, that the finding of treasure-trove is the receipt of taxable income (no indication being given as to the effect of the finder's rejection of his find). See *Revenue Ruling 61*, 1953-1 C. B. 17. This is not surprising. For if the decision below is correct, it is difficult to see why all enrichments, including *a fortiori* the accidental finding of treasure-trove, would not constitute income. A finder at least does something and his find if he accepts it is the result of his own free and uncontrolled action.

II.

CONCLUSION

For the foregoing reasons, the decision of the Court below is incorrect and should be reversed.

Respectfully submitted,

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December, 1954.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1954

No. 114

GENERAL AMERICAN INVESTORS COMPANY, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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Respondent in effect concedes that the Court below was right in saying that any attempt to dist. guish this case from *Commissioner* v. *Glenshaw Glass Company* and *Commissioner* v. *William Goldman Theatres, Inc.*, No. 199 this Term, on the ground that Section 16(b) speaks of "profit realized" and says it shall "inure to" the issuer, will not bear analysis. He expressly so concedes in his brief before this Court (pp. 30-32, footnotes 16 and 17) in those two cases to which he refers as presenting a "comparable issue", and he also so conceded in his brief before the Seventh Circuit in *Commissioner* v. *Obear-Nester Glass Company* (see footnote 2, p. 15, Pet'r Main Br.).

Respondent takes the broad position that every realized gain—by which he means every realized enrichment—is gross income within the meaning of Section 22(a) of the Internal Revenue Code and is taxable as income, except to

the extent *in haec verba* exempted by Congress (Resp. Br. pp. 8, 11-12, 17). If that be true, the potential reach of an income tax would extend far beyond anything heretofore conceived of. Realized gains or enrichments resulting from the receipt of unsought for bequests, inheritances, devises, gifts, contributions to capital, to say nothing of windfalls generally, all could be subjected to *income* tax if Congress so desired. Petitioner submits that this argument proves too much and is self defeating. For determining what is income there must be some criteria more in keeping with historical conceptions and common understanding in this country and elsewhere. These criteria are to be found in prior decisions of this Court, referred to in petitioner's main brief.

Apparently recognizing the weakness of his broad position that every realized gain or enrichment constitutes income, respondent argues (Resp. Br. pp. 15-17) that the receipts here "can be said to be derived from capital and labor" because (i) petitioner "received the payments in the lawful conduct of its business", (ii) "The payments derived from a lawful claim which constituted a property right" and (iii) "Collection of an obligation created by law would appear to be as much a business transaction as the collection of any other obligation". These propositions he supports by an assumption that the insiders availed themselves personally of confidential information belonging exclusively to petitioner and by the fact that petitioner expended legal fees, and therefore effort, in connection with the recovery. This reasoning has heretofore been considered of insufficient merit to justify serious consideration by any Court in any of the Section 16(b) cases, and petitioner submits it will no more bear analysis than the reasoning drawn from the statutory terms mentioned at the outset and now conceded to be unsound.

The income taxability of the recipient of a Section 16(b) payment depends on the true nature of the receipt. It

does not depend on whether the amount by which the insider is penalized is paid over (1) only after collection activities and the incurrence of recovery expense by the issuer or (2) without such activity or expense to the issuer either because paid over (i) voluntarily as required by law or (ii) as the result of activities or recovery expense incurred by the issuer's stockholders upon failure of the issuer to act. A purely donative promise is enforceable in New York (see *Preston* v. *Commissioner*, 132 F. 2d 763 (2d Cir. 1942)); but a gift does not cease to be a gift and become taxable income merely because the promisee finds it necessary to hire a lawyer at the cost of $13,000 to enforce the donative promise. Here the receipts had their origin in the statute and not in the mechanical steps taken for recovery. And of course they had nothing to do with and were not sought for in the conduct of the issuer's business. They are wholly unlike extorted money which has its only origin in activities deliberately undertaken to obtain it.

The real essence of respondent's argument is that a Section 16(b) payment is income to the issuer because derived from a corporate property right consisting of confidential inside information used by the insider. But the assumptions underlying this argument are legally and factually incorrect. It cannot reasonably be assumed, as respondent suggests, that every insider—including every 10% stockholder however inactive he may be—"automatically obtains" inside confidential information "by virtue of his position". Section 16(b) liability is not based on the actual use of inside information but arises whether or not inside information is used. The penalty is imposed even though it is definitely proved that no inside information had in fact been available to or used by the insider. It is imposed even though the insider—or, as might happen, a lender holding his stock as collateral—disregarded any inside information and actually acted contrary to the manner in which intelligent use of it would have indicated. No theory of trustee's accountability can be applied, for

there is no trust *res*. The article from which respondent quotes (Resp. Br. p. 16) fully recognizes this.[1] Section 16(b) is a policy measure designed to be preventative in the situations covered.[2] The purpose was not to create income for the issuer from the use of inside information but to stop insiders from possible misuse of such information. The liability, as pointed out in petitioner's main brief, has been uniformly held to be penal.

In the present case there is every indication that the so-called insider's profit was derived not from inside information but from appreciation in value of stock purchase warrants brought about by appreciation in value of the stock subject to the warrants while the warrants were outstanding. Though there was no short swing trading in any economic sense, the statute technically applied since, ignoring the ownership and increase in value of the warrants, the statute treated the exercise of the warrants simply as a purchase, and compared the purchase price as computed with the proceeds received from contemporaneous stock sales.

Petitioner sees no occasion to enter into the historical discussion of direct taxes versus indirect taxes for Constitutional purposes, with which respondent deals in his brief before this Court in the *Glenshaw Glass* and *William Goldman Theatres* cases. In *Pollock* v. *Farmers' Loan and Trust Company*, 157 U. S. 429 (1895), 158 U. S. 601 (1895), and *Brushaber* v. *Union Pacific Railroad Company*, 240 U. S. 1 (1916), to which respondent there refers, this Court

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1. In the very paragraph from which his quotation is taken (Cook and Feldman, *Insider Trading under the Securities Exchange Act*, 66 Harv. L. Rev. 385, 408 (1953)), it is said: "Unlike the 'corporate opportunity' cases, however, the action may be brought even though the insider has not competed with his corporation in the use of the information"; and two pages later (p. 410) it is said: "the persons liable under the section and the measure of liability are both based upon arbitrary rules of thumb, independent of any proof of actual use of confidential information."

2. The statute does not cover purchase and sale or sale and purchase transactions where the elapsed time between them exceeds six months, nor does it cover transactions by persons other than the insiders themselves irrespective of whether inside information was turned over and used in such cases.

spoke only of income from real and personal property and from professions, trades, employments and vocations. There was no suggestion in those cases that other kinds of enrichments constituted income or, if not, that a tax thereon would not be a direct tax in the Constitutional sense. The question here is whether or not the receipts in question were intended to be, and are by their nature, income within the statutory definition of gross income. If Congress intended to tax the receipts as income to petitioner and they are income to petitioner, then they are subject to the income tax respondent seeks to impose; if Congress did not intend to tax them as income to petitioner or if they cannot be treated as income to petitioner, then they are not subject to the tax.

In pressing its case, petitioner urges this Court to bear in mind that the question of Congressional intent here involved is not one of exemption from taxation but one of double taxation. Respondent's position really is that any profit realized by the insider, taxed once to him, should be taxed a second time when upon command of the statute it is paid over to the issuer. Indeed, in many cases the combined taxes would exceed 100% of the profit. Petitioner insists Congress did not intend such double taxation when, as a matter of public policy, it chose to deter the insider by directing him to disgorge to the issuer rather than to some other recipient, whether it be the public treasury or a public charity.

Respectfully submitted,

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February, 1955

MEMORANDUM FOR THE RESPONDENT

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No. 114

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PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT

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MEMORANDUM FOR THE RESPONDENT

The Commissioner does not oppose the granting of a writ of certiorari in this case, although he believes that the decision of the court below is correct.

The question involved is whether the profits of insiders derived from short-term trading in the taxpayer's stock which were recovered by the taxpayer under Section 30 (f) of the Investment Company Act of 1940, c. 686, 54 Stat. 789 (15 U. S. C. 80a-29 (f)), and Section 16 of the Securities Exchange Act of 1934, c. 404, 48 Stat. 881 (15 U. S. C. 78p), constitute income to the

taxpayer under Section 22 (a) of the Internal Revenue Code (26 U. S. C. 22). The court below held that such profits are income within the meaning of Section 22 (a) of the Code, and relied upon the decision of the Court of Claims in *Park & Tilford Distillers Corp.* v. *United States*, 107 F. Supp. 941, involving substantially similar facts, in which this Court denied certiorari, 345 U. S. 917.

The taxpayer alleges that the decision below is in conflict with the recent decisions of the Third Circuit in *Commissioner* v. *Glenshaw Glass Co.* and *Commissioner* v. *Goldman Theatres, Inc.*, both reported in 211 F. 2d 928, in which it was held that punitive damages recovered for fraud and under the antitrust laws do not constitute income under Section 22 (a) of the Code. (Pet. 6–13.) In those cases the Third Circuit adhered to its prior decision in *Central R. Co.* v. *Commissioner*, 79 F. 2d 697, in which it had held that property received in settlement of a suit, stated to constitute a "penalty" to the payor and a "windfall" to the taxpayer-payee, did not constitute taxable income. The *Glenshaw Glass Co.* and *Goldman Theatres, Inc.*, cases are now before this Court on a petition for a writ of certiorari, No. 199, and one of the reasons assigned for granting the writ was that those decisions differ, in their interpretation of the holdings of this Court, with the decision of the

Second Circuit in this case.[1] Therefore, while we believe that the decision of the court below is correct, the Government does not oppose the granting of the writ.

SIMON E. SOBELOFF,
Solicitor General.

JULY 1954.

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[1] In opposing certiorari in *Park & Tilford*, the Government did not deny the alleged conflict with *Central R. Co.* v. *Commissioner*, but suggested that it was wrongly decided and might not be followed.

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In the Supreme Court of the United States

OCTOBER TERM, 1954

No. 114

GENERAL AMERICAN INVESTORS COMPANY, INC.,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Court of Appeals (R. 13–18) is reported at 211 F. 2d 522. The findings of fact and opinion of the Tax Court (R. 3–12) are reported at 19 T. C. 581.

JURISDICTION

The judgment of the Court of Appeals was entered on March 9, 1954 (R. 19). The petition for a writ of certiorari was filed on June 4, 1954, and was granted October 14, 1954 (R. 26). The jurisdiction of this Court rests upon 28 U. S. C., Section 1254.

QUESTION PRESENTED

Two individuals, one a director and the other a stockholder of the taxpayer-corporation, derived insider profits from short-term trading in taxpayer's stock which they paid over to taxpayer pursuant to the requirements of Section 30 of the Investment Company Act of 1940 and Section 16 of the Securities Exchange Act of 1934. The question presented is whether the amount of those profits paid over to taxpayer in 1948 constituted income to taxpayer under Section 22 (a) of the Internal Revenue Code of 1939.

STATUTES AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

> SEC. 22. GROSS INCOME.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *
>
> * * * * *
>
> (26 U. S. C. 1952 ed., Sec. 22.)

Investment Company Act of 1940, c. 686, 54 Stat. 789, 836, 837:

> SEC. 30. * * *
>
> * * * * *
>
> (f) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of outstanding securities (other than short-term paper) of which a registered closed-end company is the issuer or who is an officer, director, member of an advisory board, investment adviser, or affiliated person of an investment adviser of such a company shall in respect of his transactions in any securities of such company (other than short-term paper) be subject to the same duties and liabilities as those imposed by section 16 of the Securities Exchange Act of 1934 upon certain beneficial owners, directors, and officers in respect of their transactions in certain equity securities.
>
> (15 U. S. C. 1952 ed., Sec. 80a–29.)

Securities Exchange Act of 1934, c. 404, 48 Stat. 881, 896:

> SEC. 16. (a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered on a national securities exchange, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security or within ten days after he

becomes such beneficial owner, director, or officer, a statement with the exchange (and a duplicate original thereof with the Commission) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been any change in such ownership during such month, shall file with the exchange a statement (*and a duplicate* original thereof with the Commission) indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month.

(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court

of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection.

* * * * *

(15 U. S. C. 1952 ed., Sec. 78p.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

SEC. 29.21-1. *Meaning of Net Income.*— The tax imposed by chapter 1 is upon income. * * * In the computation of the tax various classes of income must be considered:

(a) Income (in the broad sense), meaning all wealth which flows in to the taxpayer other than as a mere return of capital. It includes the forms of income specifically described as gains and profits, including gains derived from the sale or other disposition of capital assets. * * *

(b) Gross income, meaning income (in

the broad sense) less income which is by statutory provision or otherwise exempt from the tax imposed by chapter 1. (See section 22.)

(c) Net income, meaning gross income less statutory deductions. * * *

* * * * *

SEC. 29.22(a)-1. *What Included in Gross Income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets. * * *

* * * * *

STATEMENT

The facts were stipulated (R. 23–26) and found by the Tax Court as stipulated (R. 3). They may be summarized as follows:

Taxpayer is a corporation organized under the laws of the State of Delaware and has its principal office in New York. Its 1948 federal income tax return was filed for the calendar year and on the accrual basis. (R. 23.)

On or about April 1, 1944, one of taxpayer's directors (hereinafter referred to as "Director") acquired warrants to purchase 12,228 shares of

taxpayer's common stock at five different prices ranging from $10 to $20 a share. On the same date another individual (hereinafter referred to as "Stockholder") acquired warrants of the same type to purchase 27,027 shares of taxpayer's common stock. On December 4 and 18, 1945, the Director and Stockholder both exercised their warrants by purchases of taxpayer's stock at an average purchase price of $13.75 a share. They both sold the stock on the New York Stock Exchange prior to June 17, 1946, in blocks of various sizes and for various amounts. (R. 23–24.)

Pursuant to the provisions of Section 30 (f) of the Investment Company Act of 1940 and Section 16 (b) of the Securities Exchange Act of 1934, the Director and Stockholder were required to pay over to taxpayer the profits which they had realized on the above-described purchases and sales of the common stock of taxpayer. The profits of the Director were computed to total $81,092.33, which was the amount by which the proceeds received on the sale of 27,027 shares of stock ($254,027.33) exceeded the aggregate cost of the warrants to purchase the stock ($4,800) and the aggregate subscription price paid for the stock ($168,135). The profits of the Stockholder were similarly computed to total $129,362.95. (R. 24–25.)

On January 26, 1948, taxpayer was paid a total of $170,038.04 of such profits—$129,362.95 by the Stockholder and $40,675.09 paid by the Director

(R. 25). Those amounts were received by taxpayer without litigation (R. 25) but taxpayer expended $13,000 as legal fees in connection with their recovery (R. 6, 25). The Director and Stockholder paid the amounts upon the advice of their counsel that they were liable to taxpayer therefor (R. 25).

Taxpayer did not report the $170,038.04 as income in its 1948 income tax return. The Commissioner determined a deficiency against taxpayer for 1948 on the ground that $157,038.04 thereof (the $170,038.04 less legal expenses of $13,000) constituted realized gain taxable to petitioner under Section 22 (a) of the Internal Revenue Code (R. 3). The Tax Court upheld the Commissioner's determination (R. 6–12) and the Court of Appeals affirmed (R. 13–18).

SUMMARY OF ARGUMENT

Section 22 (a) defines "gross income" to include "gains or profits and income derived from any source whatever." This language, as consistently interpreted by this Court, plainly declares subject to tax all gain received by a taxpayer, except such gain as has been by law specifically exempted by tax. It is undisputed that the receipt by taxpayer of the "insider profits" here in issue represented realized gain. Taxpayer had unrestricted discretion to use these funds for any purpose whatsoever and they were in no sense contributions to, or returns of, capital. Nor is it suggested that they were exempt from tax as

gifts. It follows that the receipts must be included in gross income under Section 22 (a).

Taxpayer's contention that the payments did not constitute income is based on the definition of income used by this Court to distinguish income from capital in *Eisner* v. *Macomber*, 252 U. S. 189, 207—"the gain derived from capital, from labor, or from both combined." Its argument is premised on the untenable assumption that the Code "makes no attempt to define income" and that the *Eisner* v. *Macomber* definition is essential lest the determination of what constitutes income be left to "judicial hunch."

But Section 22 (a) explicitly defines income. Since the statutory definition is clear and plainly covers the receipts here in issue, there is no occasion to improvise any other guiding rule for the determination of what constitutes income. In any event, as many decisions of this Court indicate, the *Eisner* v. *Macomber* definition is not controlling in determining what constitutes income under Section 22 (a).

Of course, most gain, including Section 16 (b) payments, can be said to be derived from capital or labor or both. The "insider profits" here in issue were received by taxpayer in the lawful conduct of its business. Section 16 (b) is based on the principle that the confidential information which a corporate insider obtains by virtue of his position belongs to the corporation. Having availed himself personally of this information, the

insider is made liable directly to the corporation and indirectly to all its shareholders for the profits he realizes. Receipt of the gain, moreover, required effort on the part of the corporation to collect it. Taxpayer's contention that it did nothing to perfect its rights to the payments is untenable in view of the fact that it paid $13,000 in legal fees for services rendered in connection with the recovery of the sums due.

Whether we look for guidance to the plain words of the statute or to the gloss derived from the *Eisner* v. *Macomber* definition, the receipts of "insider profits" constituted taxable income. Congress has been articulate in exempting receipts which it intended should not be taxed as income. There is no room for the creation by judicial construction of new non-statutory exceptions to Section 22 (a).

ARGUMENT

THE INSIDER PROFITS PAID OVER TO TAXPAYER IN 1948 CONSTITUTED TAXABLE INCOME TO TAXPAYER UNDER SECTION 22 (a) OF THE INTERNAL REVENUE CODE OF 1939

This case presents the issue whether certain receipts—"insider profits"—which constituted realized gain to taxpayer and are not specifically exempted from tax are taxable to taxpayer under Section 22 (a) of the Internal Revenue Code of 1939. The decision below follows the decision of the Court of Claims in *Park & Tilford Distillers Corp.* v. *United States*, 107 F. Supp. 941, certi-

orari denied, 345 U. S. 917, where such receipts were held taxable under Section 22 (a) as "gains or profits and income derived from any source whatever." A comparable issue is presented in *Commissioner* v. *Glenshaw Glass Co. and William Goldman Theaters, Inc.*, No. 199, this Term, which involves the taxability of punitive damages. Inasmuch as our position is fully stated in our brief and reply brief in *Glenshaw*, to which the Court is respectfully referred, our brief herein will be limited to a summary statement of our position, together with such further matters as are indicated by the somewhat different circumstances of this case and the arguments advanced in taxpayer's brief.

Section 22 (a) of the Internal Revenue Code of 1939 defines "gross income" to include "gains or profits and income derived from any source whatever." This language, as consistently interpreted by this Court, plainly declares subject to tax all gain received by a taxpayer, except such income or gain as has been by law specifically exempted from tax. The issue here concerns the taxability of "insider profits" paid over to taxpayer in 1948, pursuant to Section 30 (f) of the Investment Company Act of 1940 and Section 16 (b) of the Securities Exchange Act of 1934.

It is undisputed that these payments represented realized gain to taxpayer. As noted by the court below (R. 17), taxpayer had unrestricted discretion to use the funds paid over to

it for any purpose whatsoever; they were in no sense contributions to capital,[1] or payments by way of restoration of lost capital, or compensation for any loss suffered by petitioner. Nor were the payments, gifts, or any other type of gain specifically exempted from tax under Section 22 (a), and taxpayer does not argue otherwise. It follows under the plain terms of the statute that the receipts of "insider profits" must be included in "gross income" under Section 22 (a).

Taxpayer apparently recognizes that the statutory definition is constitutional and that the payments here involved constituted gain to it. Its

[1] Taxpayer apparently considers that the insider profits were in the nature of a windfall to the corporation (see Br. 9–11) although it asserts that they "resemble" legally enforced capital contributions and that, in the circumstances of this case, the corporate receipts were "very much akin" to the receipt of part of the subscription price of newly issued shares (Br. 11). The court below properly rejected the contention that the payments were part of the subscription price of newly issued shares (R. 17–18) and taxpayer has not made that contention here. Taxpayer does state that it "would seem especially appropriate" to treat the payments as "capital in nature" as if made pursuant to "the subscription contract itself" (Br. 12). But since the insider profits were not in fact part of the subscription price of stock and were received by taxpayer without any restriction as to their use, they do not fall into the category of a nontaxable capital contribution. See *Texas & Pacific Ry. Co.* v. *United States*, 286 U. S. 285, and pages 39–40 of our brief in the *Glenshaw* case. See further Darrell, *The Tax Treatment of Payments under Section 16 (b) of the Securities Exchange Act of 1934*, 64 Harv. L. Rev. 80, 94–95 (1950).

argument that the payments did not constitute income under Section 22 (a) is based simply upon the definition of income used by this Court in *Eisner* v. *Macomber,* 252 U. S. 189, 207—"the gain derived from capital, from labor, or from both combined." Taxpayer suggests that the comprehensive language of Section 22 (a) is restricted in meaning by what it calls "the source language" or the "source rule" of the *Eisner* v. *Macomber* definition (Br. 21, 23). That suggestion is premised on the patently incorrect statement that Section 22 (a) of the Code "makes no attempt to define income" (Br. 17–18). On this premise, taxpayer urges acceptance of the *Eisner* v. *Macomber* definition lest the determination of what constitutes income be left without any guiding rule other than a "judicial hunch" (Br. 24).

Section 22 (a) does, of course, define income. Section 22 (a) itself is captioned "General Definition." "Gross Income" for the purposes of the Code is defined as including "gains, profits, and income" derived from certain specified sources and, comprehensively, as including "gains or profits and income derived from any source whatever." To the extent that it defines income as including all gains and profits, the statute in unequivocal language prescribes a guiding rule for the determination of what constitutes income. Thus, so far as the present case is concerned, if the

words "gains * * * derived from any source whatever" are given their usual meaning, then, as the court below rhetorically asked (R. 17), "how can there be any doubt that these Section 16 (b) payments are 'income'?"

Since the language of Section 22 (a) is clear, and covers this case, there is no occasion here to improvise any other guiding rule for the determination of what constitutes income.[2] Moreover, it is clear that the *Eisner* v. *Macomber* definition, which was adopted and has been used by this Court for an entirely different purpose, i. e., to distinguish income from capital,[3] does not illuminate the problem. Taxpayer itself has trouble with the *Eisner* v. *Macomber* definition. On the one hand, taxpayer characterizes the definition as "profoundly perceptive" (Br. 20). On the other hand it asserts that the definition is to be "interpreted broadly" (Br. 19), and suggests that all of the

[2] Nor is there any occasion to explore the popular meaning of "income." But we think that the payments here in issue, like the payments of punitive damages in the *Glenshaw* case, would be considered income in the popular sense as well. Periodicity, certainly, is no test of income, as the many decisions of this Court holding non-recurrent receipts to be income attest. See, *e. g.*, cases cited, page 15, *infra*. The payments in issue were received in the course of transaction of a business, they constituted gain in every sense of the word, they were received free of any obligation whatsoever and were not intended to be and were not in fact contributions to capital or return of capital. This is income in the popular sense.

[3] See, *e. g.*, *Helvering* v. *Bruun*, 309 U. S. 461, 468-469.

receipts held by this Court to be taxable under Section 22 (a) could be construed to come "within the broad meaning" and "under a reasonable interpretation" of the "source language" of the definition (Br. 21, 23), including *United States* v. *Kirby Lumber Co.*, 284 U. S. 1 (gain from purchase of taxpayer's own obligations at a discount); *Helvering* v. *Bruun*, 309 U. S. 461 (gain received on forfeiture of lease on which lessee had erected a building); and *Rutkin* v. *United States*, 343 U. S. 130 (gain consisted of extorted money). Thus taxpayer, itself, in order to accommodate the decisions of this Court under Section 22 (a), would nullify the restrictive implications of the "source language" of the *Eisner* v. *Macomber* definition on which it relies. To say that these decisions are reconcilable is merely to recognize that most, if not all, gain can be said to be derived from capital or labor or both. See further our reply brief in *Glenshaw*, at pp. 7–10.

Indeed, the gain here too can be said to be derived from capital and labor. Taxpayer received the payments in the lawful conduct of its business. The payments derived from a lawful claim which constituted a property right. Collection of an obligation created by law would appear to be as much a business transaction as the collection of any other obligation. The lawful claim derived from Section 16 (b). That section was designed "to protect the interests of the pub-

lic by preventing [insiders] from speculating in the stock on the basis of information not available to others."[4] In providing that the insiders' profits must be paid over to the corporation, Congress appears to have been proceeding "on the principle that the confidential information which a corporate insider automatically obtains by virtue of his position belongs to the corporation."[5] Having availed himself personally of this information, the insider is made liable directly to the corporation and indirectly to all its shareholders for the profits he realizes. The gain may thus be said to have been derived from property belonging exclusively to the corporation. Receipt of that gain, moreover, required effort on the part of the corporation to collect it. Taxpayer's contention that it did nothing to perfect its right to the payments concerned (Br. 9–10) is hardly tenable in view of the fact that it is undisputed that taxpayer paid $13,000 in legal fees in payment for services rendered in connection with the recovery of the sums due (R. 6, 25).[6] Thus the receipts involved here consist of "gain derived from capi-

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[4] S. Rep. No. 792, 73d Cong., 2d Sess., p. 9; cf. H. Rep. No. 1383, 73d Cong., 2d Sess., p. 13.

[5] Cook and Feldman, *Insider Trading under the Securities Exchange Act*, 66 Harv. L. Rev. 385, 408 (1953). Mr. Cook was at the time chairman and Mr. Feldman special counsel of the Securities and Exchange Commission (*id.*, 385).

[6] The concurring judges in the Tax Court buttressed their conclusion that the Section 16 (b) payments were income under Section 22 (a) with the observation that Section 16 (b) itself terms the payments as "profits" and provides that

tal, from labor, or from both combined" when that phrase is interpreted in the light of present decisions of this Court.[7] The "insider profits" patently had a more direct origin in taxpayer's capital and labor than did, for example, the extorted money held by this Court to be income in *Rutkin* v. *United States,* 343 U. S. 130.

The essential characteristics of the receipts in question are that they constituted realized gain to taxpayer and have not been exempted by Congress from tax. Taxpayer does not contest either of these propositions, which in our view dispose of the case. But whether we look for guidance to the plain words of the statute or to the gloss derived from the definition of income used by this Court in *Eisner* v. *Macomber,* the receipts of "insider profits" here involved constituted taxable income within the broad scope of Section 22 (a). This Court has many times affirmed the comprehensive scope of that section. Congress

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they "shall inure to and be recoverable by the issuer" (R. 11–12).

[7] This case does not present the question of the tax liability of the insider on his gain, if any, resulting from the security transactions which give rise to liability under Section 16 (b). See I. T. 4069, 1952–1 Cum. Bull. 28; *William F. Davis, Jr.,* 17 T. C. 549; *cf.* Cook and Feldman, *Insider Trading under the Securities Exchange Act,* 66 Harv. L. Rev. 385, 615–617 (1953).

has been articulate in exempting from Section 22 (a) receipts which it intended should not be taxed as income. Although Congress has recently completed a comprehensive revision of the Internal Revenue Code and, as noted by taxpayer, has included in the law certain additional exclusions from income for purposes of the income tax (Pet. Br., p. 22, n. 4), Congress did not seek to disturb the rule of *Park and Tilford Distillers Corp.* v. *United States,* 107 F. Supp. 941 (C. Cls.), certiorari denied, 345 U. S. 917, that "insider profits" are taxable as income to the recipient corporation. And as we have demonstrated, there is no sanction for the creation of new nonstatutory exceptions to Section 22 (a) by a process of judicial construction.

CONCLUSION

The decision below is correct and should be affirmed.

Respectfully submitted,

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